CLERK'S COPY.

TRANSCRIPT OF RECORD

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1944

No. 371

COMMISSIONER OF INTERNAL REVENUE,
PETITIONER

vs.

JOHN H. SMITH

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

PETITION FOR CERTIORARI FILED AUGUST 18, 1944
CERTIORARI GRANTED OCTOBER 16, 1944

No. 10478

United States
Circuit Court of Appeals
For the Ninth Circuit.

JOHN H. SMITH,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Transcript of the Record

Upon Petition to Review a Decision of the Tax Court of the United States

Rotary Colorprint, 590 Folsom St., San Francisco

INDEX

[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

	Page
Answer	18
Appearances	1
Certificate of Clerk to Transcript of Record	171
Decision	37
Designation of Record	169
Docket Entries	1
Findings of Fact and Opinion, Memorandum	21
Opinion	30
Petition for Redetermination of Deficiency	3
Exhibit A—Notice of Deficiency	12
Petition for Review	161
Notice of Filing	165
Statement of Points to Be Relied Upon	166
Transcript of Hearing	38
Exhibits for Petitioner:	
1—Reorganization Indenture Between Hawley Pulp and Paper Company and Depositing Security Holders of Hawley Pulp and Paper Company, January 18, 1934	50

Index **Page**

Exhibits for Petitioner (Continued):

2—Extract from Records of Board of Directors at Meeting Held May 4, 1937 77

3—Opinion Agreement Between Western Cooperage Company and John H. Smith 82

4—Check Drawn to Western Cooperage Company, Dated March 21, 1938, Signed by John H. Smith, Jr. 88

5—Letter, March 18, 1938, Addressed to Mr. Day, The Bank of California, National Association, Depositary from Western Cooperage Company 96

6—List of Local Securities Price Range—4 Years—Bid Quotations Provided by Bond Traders' Club of Portland, "Oregon Voter" for June 12, 1937 102

7—Copy of Journal Entries, December 12, 1938 148

Index Page

Schedule E from Income Tax Return of Western Cooperage Co. for 1939 153

Witnesses for Petitioner:

Carter, M. D.
—direct 131
—cross 149

Livingstone, Colin
—direct 129
—cross 131

Peck, Cassius R.
—direct 114
—cross 119
—redirect 121

Smith, John H.
—direct 41
—cross 104
—redirect 107
—recalled, redirect 156, 159
—recross 158

Proceedings in U. S. C. C. A., Ninth Circuit 173
Order of submission 173
Order directing filing of opinion and judgment 173
Opinion, Mathews, J 173
Judgment 176
Clerk's certificate 176
Order allowing certiorari 177

APPEARANCES:

For Taxpayer:
CLARENCE D. PHILLIPS, Esq.,

For Comm'r:
E. A. TONJES, Esq.,
R. C. WHITLEY, Esq.

Docket No. 110050.

JOHN H. SMITH,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DOCKET ENTRIES

1942

Mar. 2—Petition received and filed. Taxpayer notified. Fee paid.

Mar. 2—Copy of petition served on General Counsel.

Apr. 15—Answer filed by General Counsel.

Apr. 15—Request for hearing in Portland, Oregon, filed by General Counsel.

Apr. 18—Notice issued placing proceeding on Portland, Oregon, calendar. Service of answer and request made.

Aug. 7—Hearing set Sept. 14, 1942, in Portland, Oregon.

1942

Sept. 17—Hearing had before Miss Harron on merits. Submitted. Briefs due 11-2-42. Replies 11-17-42.

Oct. 14—Transcript of hearing 9-17-42 filed.

Oct. 27—Brief filed by taxpayer.

Nov. 2—Motion for extension to Nov. 17, 1942, to file brief filed by General Counsel.

Nov. 3—Order extending time to Nov. 17, 1942, to file brief of respondent, and to Dec. 17, 1942, to file both reply briefs, entered.

Nov. 17—Brief filed by General Counsel, Served 11-18-42.

Nov. 18—Copy of brief served on General Counsel.

Dec. 14—Reply brief filed by taxpayer. 12-14-42 Copy served on General Counsel.

1943

Feb. 26—Memorandum Findings of fact and Opinion rendered. Harron, Judge. #13. Decision will be entered under Rule 50. 2-26-43 Copy served.

Mar. 18—Computation of deficiency filed by General Counsel.

Mar. 24—Hearing set April 7, 1943, on settlement.

Apr. 7—Hearing had before Judge Murdock on settlement under Rule 50. Respondent's computation not contested. Referred to Judge Harron for decision.

Apr. 7—Decision entered. Harron, Judge. Div. 13.

May 19—Petition for review by U. S. Circuit Court of Appeals 9th Circuit, filed by taxpayer.

1943

Jun. 9—Proof of service of filing petition for review filed by taxpayer.

Jun. 9—Statement of points to be relied upon, filed by taxpayer with proof of service thereon.

Jun. 9—Agreed designation of portions of record proceedings and evidence to be contained in record, filed [1*]

Before the United States Board of Tax Appeals

Docket No. 110050.

JOHN H. SMITH,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION

The above named Petitioner hereby petitions for a redetermination of income tax liability for the calendar year ended December 31, 1938, and for the calendar year ended December 31, 1939, as determined by the Commissioner of Internal Revenue in his notice of deficiency dated January 31, 1942, and as a basis of this proceeding the Petitioner alleges as follows:

*Page numbering appearing at top of page of original certified Transcript of Record.

I.

That the Petitioner is an individual whose business address is 1233 American Bank Building, Portland, Oregon, and that the said Petitioner filed with the Collector of Internal Revenue, for the District of Oregon, at Portland, Oregon, his income tax returns for the calendar year 1938 and for the calendar year 1939.

II.

Notice of deficiency (a copy of which is hereto [2] attached and marked Exhibit A) was mailed to the Petitioner on January 31, 1942.

III.

The taxes in controversy are income taxes for the calendar year 1938 and the calendar year 1939; the deficiency asserted for the calendar year 1938 is the sum of $33,502.64, together with a penalty thereon of $1675.13; that the deficiency asserted for the calendar year 1939 is the sum of $29,444.39, together with a penalty thereon in the sum of $1472.22; that the total deficiency asserted for both years is the sum of $62,947.03, and the total penalty asserted is the sum of $3,147.35, and that all of said amounts are in controversy.

IV.

The determination of tax set forth in said notice of deficiency is based upon the following errors:

(a) In determining the taxable net income of the Petitioner for the calendar year 1938, the Commissioner erroneously included income in the amount of $81,021.60, which the Commissioner

claims the Petitioner received as income by reason of his purchase from Western Cooperage Company during the calendar year 1938 of voting trust certificates representing 33,759 shares of the Common [3] Capital Stock of Hawley Pulp and Paper Company. The Petitioner claims that the said $81,-021.60 was not income under the provisions of Section 22 (a) of the Revenue Act of 1938 or under the provisions of Regulations 101 promulgated thereunder.

(b) In determining the taxable net income of the Petitioner for the calendar year 1938, and in computing the asserted deficiency thereon, the Commissioner has asserted a penalty in the amount of $1675.13. The Petitioner claims that there was no negligence or intentional disregard of the rules and regulations in not reporting in his income tax return for the year 1938 the purchase of the voting trust certificates referred to in paragraph (a) above, and that the Commissioner unlawfully and erroneously assessed such penalty under the provisions of Section 293 (a) of the Revenue Act of 1938.

(c) In determining the taxable net income of the Petitioner for the calendar year 193 he Commissioner erroneously included income in the amount of $71,660.98, which the Commissioner claims the Petitioner received as income by reason of his purchase from Western Cooperage Company during the calendar year [4] 1939 of voting trust certificates representing 12,404 shares of the Common Capital Stock of Hawley Pulp and Paper Company. The Petitioner claims that the said $71,-

650.98 was not income under the provisions of Section 22 (a) of the Revenue Act of 1938, or under the provisions of Regulations 101 promulgated thereunder.

(d) In determining the taxable net income of Petitioner for the calendar year 1939, the Commissioner erroneously disallowed a deduction on account of the worthlessness of four units of interest in San Juan Mining Syndicate purchased by Petitioner July 17, 1937, for $1000.00. The units in said Syndicate became worthless during the year 1939. The Commissioner disallowed a deduction to the extent of $166.66. Petitioner claims that by reason of the worthlessness of said four units of interest in San Juan Mining Syndicate during the calendar year 1939 that Petitioner should be allowed a deduction of $1000.00 as an ordinary loss under the provisions of Section 23 (e) of the Revenue Act of 1938.

(e) In determining the taxable net income of the Petitioner for the calendar year 1939, and in computing the asserted deficiency thereon, the Commissioner has asserted a penalty in the amount of $1,472.22. The [5] Petitioner claims that there was no negligence or intentional disregard of the rules and regulations in not reporting in his income tax return for the year 1939 the purchase of voting trust certificates referred to in paragraph (c) above, and that the Commissioner unlawfully and erroneously assessed said penalty under the provisions of Section 293 (a) of the Revenue Act of 1938.

V.

The facts upon which the Petitioner relies as the basis for this proceeding are as follows:

(a) On December 10, 1934, in consideration of services rendered prior to December 10, 1934, Western Cooperage Company gave to the Petitioner an option to purchase, on or before January 1, 1940, at a purchase price of 10 cents per share, the right to receive all of the Common Stock of Hawley Pulp and Paper Company in excess of 100,001 shares to be received by the said Western Cooperage Company. The purchase price of said stock as fixed in said option was not less than the fair market value of the said stock, or the voting trust certificates representing said stock, on December 10, 1934. The said option was subsequently ratified and [6] approved by the Board of Directors of Western Cooperage Company. Thereafter, in March, 1938, the Petitioner exercised his right under said option and purchased from Western Cooperage Company voting trust certificates representing 74,377 shares of Common Stock of Hawley, Pulp and Paper Company. The said purchase was made pursuant to and in accordance with the terms of the said option agreement at a total purchase price of $7,437.70, as provided in said option, and said purchase price was paid by Petitioner to Western Cooperage Company during the calendar year 1938.

During the calendar year 1938, in accordance with instructions given by Western Cooperage Company to the depositary holding said voting trust certificates, there was delivered to Petitioner under

the terms of said option voting trust certificates representing 33,759 shares of Common Stock of Hawley Pulp and Paper Company. The said voting trust certificates, or the Common Stock of Hawley Pulp and Paper Company represented thereby, were not received by the taxpayer during the calendar year 1938 as compensation for services, and that the taxpayer paid therefor the price agreed upon in the option agreement, which price was not less than [7] the fair market value at the time of the giving of said option on December 10, 1934.

(b) That the said option agreement given as of December 10, 1934, referred to in paragraph (a) above, was given to the Petitioner by Western Cooperage Company in payment of services rendered prior to December 10, 1934, and that the said option on December 10, 1934, was considered of only nominal value, and if the Petitioner received any compensation by reason of said option agreement or the receipt of shares thereunder, the said compensation was received at the time he received the option, and that the Petitioner received no compensation during the calendar year 1938 for services by reason of the receipt of said voting trust certificates or the shares represented thereby. That Petitioner was not required to report any compensation on such a transaction and the Commissioner erroneously assessed a penalty in addition to the asserted deficiency in the tax.

(c) On December 10, 1934, in consideration of services rendered prior to December 10, 1934, Western Cooperage Company gave to the Petitioner an

option to purchase, on or before January 1, 1940, at a purchase price of 10 cents per share, the right to receive all [8] of the Common Stock of Hawley Pulp and Paper Company in excess of 100,001 shares to be received by the said Western Cooperage Company. The purchase price of said stock as fixed in said option was not less than the fair market value of the said stock or voting trust certificates representing said stock on December 10, 1934. The said option was subsequently ratified and approved by the Board of Directors of Western Cooperage Company. Thereafter, in March, 1938, the Petitioner exercised his right under said option and purchased from Western Cooperage Company voting trust certificates representing 74,377 shares of Common Stock of Hawley Pulp and Paper Company. The said purchase was made pursuant to and in accordance with the terms of the said option agreement at a total purchase price of $7,437.70, as provided in said option, and said purchase price was paid by Petitioner to Western Cooperage Company during the calendar year 1938.

During the calendar year 1939, in accordance with instructions given by Western Cooperage Company to the depositary holding said voting trust certificates, there was delivered to Petitioner under the terms of said option, voting trust certificates representing 12,404 shares of Common Stock of Hawley Pulp and Paper Company. [9] The said voting trust certificates or the Common Stock of Hawley Pulp and Paper Company represented thereby were not received by the taxpayer during the calendar year 1939 as compensation for services, and that

the taxpayer had theretofore in 1938 paid for said shares the price agreed upon in the option agreement, which price was not less than the fair market value at the time of the giving of said option on December 10, 1934.

(d) That on July 17, 1937, the Petitioner purchased, for the sum of $1000.00, four units of interest in San Juan Mining Syndicate. Thereafter, and on or about April 25, 1939, the said San Juan Mining Syndicate found that it was unable to properly finance itself, and lost all of its properties or rights to property during the calendar year 1939. The San Juan Mining Syndicate was dissolved on or about April 25, 1939. There was no distribution of assets and no assets left to distribute to the owners of the units of interest, and the Petitioner has received no dividends, either liquidating or otherwise, from said San Juan Mining Syndicate, and said units were determined to be worthless in the calendar year 1939. The loss sustained by the Petitioner was in the sum of $1000.00, and was an ordinary loss deductible [10] from gross income under the provisions of Section 23 (e) of the Revenue Act of 1938.

(e) That the option agreement given as of December 10, 1934, referred to in paragraph (c) above was given to the Petitioner by Western Cooperage Company in payment of services rendered prior to December 10, 1934, and that the said option on December 10, 1934, was considered of only nominal value, and if the Petitioner received any compensation by reason of said option agreement or the receipt of shares thereunder, the said compensation

was received at the time he received the option, to-wit, December 10, 1934, and that the Petitioner received no compensation during the calendar year 1939 for services by reason of the receipt of said voting trust certificates or the shares represented thereby. That Petitioner was not required to report any compensation on such a transaction and the Commsisioner erroneously assessed a penalty in addition to the asserted deficiency in the tax.

VI.

That the Petitioner is entitled to have his tax redetermined for the calendar years 1938 and 1939, and contends that there is no further tax due for the [11] calendar years 1938 and 1939, and that for the calendar year 1939 there should be refunded to the Petitioner the sum of $70.00 by reason of Petitioner's failure to deduct the full amount of his loss occasioned by the worthlessness of four units in San Juan Mining Syndicate, which were determined to be worthless and written off during the calendar year 1939.

Wherefore, Petitioner prays that the Board may hear the proceeding and determine that there is no deficiency due from the Petitioner for the calendar years 1938 and 1939, and that for the calendar year 1939 there was an overpayment of tax in the amount of $70.00, and that the Petitioner is entitled to a refund in the sum of $70.00, together with interest

thereon at the rate of 6 per cent. per annum from December 15, 1940.

JOHN H. SMITH,
Petitioner.
(Sgd) CLARENCE D. PHILLIPS
Clarence D. Phillips,
805 Electric Building,
Portland, Oregon,
Attorney for Petitioner.

Counsel:
Griffith, Peck, Phillips & Nelson,
805 Electric Building,
Portland, Oregon.
(Duly verified.) [12]

EXHIBIT A

Treasury Department
Internal Revenue Service
Seattle, Washington
January 31, 1942

Office of
Internal Revenue Agent
in Charge
Seattle Division
350 Federal Office Building

IT:90D:JW

Mr. John H. Smith,
1233 American Bank Building,
Portland, Oregon.

Sir:

You are advised that the determination of your

income tax liability for the taxable year(s) ended Dec. 31, 1938 & 1939, discloses a deficiency of $62,947.03 and $3,147.35 in penalty as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency mentioned.

Within 90 days (not counting Sunday or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with the United States Board of Tax Appeals for a redetermination of the deficiency.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to Internal Revenue Agent in Charge, Seattle, Washington, for the attention of IT:90D:JW. The signing and filing of this form will expedite the closing of your return(s) by permitting an early assessment of the deficiency, and will prevent the accumulation of interest, since the interest period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully,

GUY T. HELVERING,
Commissioner,

By GEO. C. EARLEY,
Internal Revenue Agent in Charge

Enclosures:
Statement.
Form of waiver.
JW-bb [14]

STATEMENT

IT:90D:JW

Mr. John H. Smith,
1233 American Bank Building,
Portland, Oregon.

Tax Liability for the Taxable Years Ended December 31, 1938 and December 31, 1939

INCOME TAX

	Liability	Assessed	Deficiency	Penalty
1938	$ 35,861.77	$ 2,359.13	$ 33,502.64	$ 1,675.13
1939	32,562.87	3,118.48	29,444.39	1,472.22
Totals	$68,424.64	$ 5,477.61	$ 62,947.03	$ 3,147.35

In making this determination of your income tax liability, careful consideration has been given to the reports of examination dated March 13, 1941, and to the revised statement dated October 1, 1941, covering the liability for the year 1939; to your protests dated June 10, 1941; and to the statements made at the conferences held on August 22, 1941, November 24, 1941, and January 13, 1942.

The advalorem penalties imposed by Section 293 (a) of the Revenue Act of 1938 and by Section 293 (a) of the Internal Revenue Code, are asserted because of your failure to report, in your returns filed for the taxable years 1938 and 1939, the transactions in those years wherein you acquired from Western Cooperage Company voting trust certificates representing shares of the common capital stock of Hawley Pulp and Paper Company for less than their

fair market value, and because of your failure to include in gross income in your said returns the differences between the amounts paid for such voting trust certificates and the amounts of their fair market values, as required by Article 22(a)-1 of Regulations 101 and by Section 19.22(a)-1 of Regulations 103.

A copy of this letter and statement has been mailed to your representative, Clarence D. Phillips, 805 Electric Building, Portland, Oregon, in accordance with the authority contained in the power of attorney executed by you. [15]

TAXABLE YEAR ENDED DECEMBER 31, 1938

Adjustments to Net Income		
Net income as disclosed by return		$ 25,868.90
Unallowable deductions and additional income:		
(a) Income understated	$81,021.60	
Net income adjusted		$106,890.50

EXPLANATION OF ADJUSTMENT

(a) During the taxable year 1938 you acquired from Western Cooperage Company, for a total price of $3,375.90, pursuant to the terms of an option granted to you by that corporation on or about May 4, 1937, voting trust certificates entitling you to receive 33,759 shares of the common capital stock of Hawley Pulp and Paper Company. The fair market value, at the time of their receipt by you, of the said voting trust certificates was $84,397.50. The excess of the latter amount over the $3,375.90 paid by you pursuant to said option constitutes in-

come to you under Section 22(a) of the Revenue Act of 1938, and is included as a part of your net income for the year 1938 in accordance with the provisions of Article 22(a)-1 of Regulations 101.

COMPUTATION OF TAX

Net income adjusted		$106,890.50
Less: Personal exemption	$2,500.00	
Credit for dependents	1,200.00	3,700.00
Balance (surtax net income)		$103,190.50
Less: Earned income credit (10% of $14,000.00)		1,400.00
Net income subject to normal tax		$101,790.50
Normal tax at 4% on $101,790.50		$ 4,071.62
Surtax on $103,190.50		31,850.49
Total tax		$ 35,922.11
Less: Income tax paid to a foreign country or U. S. possession		60.34
Corrected income tax liability		$ 35,861.77
Income tax assessed:		
Original, Account No. 20625		2,359.13
Deficiency of income tax		$ 33,502.64

[16]

TAXABLE YEAR ENDED DECEMBER 31, 1939

Adjustments to Net Income

Net income as disclosed by return		$ 29,716.90
Unallowable deductions and additional income:		
(a) Income understated	$ 71,660.98	
(b) Capital loss overstated	166.66	71,827.64
Net income adjusted		$101,544.54

EXPLANATION OF ADJUSTMENTS

(a) During the taxable year 1939 you acquired from Western Cooperage Company, for a total price of $1,240.40, pursuant to the terms of an option granted to you by that corporation on or about May 4, 1937, voting trust certificates entitling you to receive 12,404 shares of the common capital stock of Hawley Pulp and Paper Company. The fair market value, at the time of their receipt by you, of the said voting trust certificates was $72,901.38. The excess of the latter amount over the $1,240.40 paid by you pursuant to said option constitutes income to you under Section 22(a) of the Internal Revenue Code, and is included as a part of your net income for the year 1939 in accordance with the provisions of Section 19.22(a)-1 of Regulations 103.

(b) You claimed a loss of $666.66 on worthlessness of four units of interest in San Juan Mining Syndicate, purchased July 17, 1937, for $1,000.00. As the time from date of purchase to the close of the year in which worthlessness occurred was over two years, the allowable loss is limited to 50%, or $500.00. Excessive deduction, $166.66. [17]

Taxable Year Ended December 31, 1939—(Continued)

COMPUTATION OF TAX

Net income adjusted		$101,544.54
Less:		
Personal exemption	$2,500.00	
Credit for dependents	1,200.00	3,700.00
Balance (surtax net income)		$ 97,844.54

Less:	
Earned income credit (10% of $14,000.00)	1,400.00
Net income subject to normal tax	$ 96,444.54
Normal tax at 4% on $96,444.54	$ 3,857.78
Surtax on $97,844.54	28,814.50
Total tax	$ 32,672.28
Less:	
Income tax paid to a foreign country or U. S. possession	109.41
Corrected income tax liability	$ 32,562.87
Income tax assessed:	
Original, Account No. 20038	3,118.48
Deficiency of income tax	$ 29,444.39

[Endorsed]: U.S.B.T.A. Filed Mar. 2, 1942. [18]

[Title of Board and Cause.]

ANSWER

Comes Now the Commissioner of Internal Revenue, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and for answer to the petition filed herein, admits and denies as follows:

1. Admits the allegations contained in paragraph I of the petition.

2. Admits the allegations contained in paragraph II of the petition.

3. Admits the allegations contained in paragraph III of the petition.

4. Denies that he erred in his determination of

the deficiencies as shown by the notice of deficiency from which petitioner's appeal is taken. Specifically denies that he erred in the manner and form as alleged in subparagraphs (a) to (e), inclusive, of paragraph IV of the petition.

5(a). Admits that in consideration of services rendered or to be rendered, Western Cooperage Company gave to the petitioner an option to purchase, on or before January 1, 1940, at a purchase price of 10 cents per share, the right to receive all of the common stock of Hawley Pulp and Paper Company in excess of 100,001 shares to be received by said [19] Western Cooperage Company, that thereafter, in March, 1938, petitioner exercised his right under said option to purchase said common stock; that during the calendar year 1938, there was delivered to petitioner under the terms of said option, voting trust certificates representing 33,759 shares of common stock of Hawley Pulp and Paper Company; and that the petitioner paid therefor the price agreed upon in the option agreement. Denies the remaining allegations contained in subparagraph (a) of paragraph V of the petition.

(b) Denies the allegations contained in subparagraph (b) of paragraph V of the petition.

(c). Admits that in consideration of services rendered or to be rendered, Western Cooperage Company gave to the petitioner an option to purchase, on or before January 1, 1940, at a purchase price of 10 cents per share, the right to receive all common stock of Hawley Pulp and Paper Company in excess of 100,001 shares to be received by said

Western Cooperage Company; that thereafter, in March 1938, the petitioner exercised his right under said option to purchase said common stock; that during the calendar year 1939, there was delivered to petitioner under the terms of said option, voting trust certificates representing 12,405 shares of common stock of Hawley Pulp and Paper Company; and that petitioner paid for said shares the price agreed upon in the option agreement. Denies the remaining allegations contained in subparagraph (c) of paragraph V of the petition.

(d). Admits that on July 17, 1937, the petitioner purchased, for the sum of $1,000, four units of interest in San Juan Mining Syndicate. [20] Denies the remaining allegations contained in subparagraph (d) of paragraph V of the petition.

(e). Denies the allegations contained in subparagraph (e) of paragraph V of the petition.

6. Denies the allegations contained in paragraph VI of the petition.

7. Denies generally and specifically each and every material allegation contained in the petition herein, not hereinbefore specifically admitted, qualified, or denied.

Wherefore, it is prayed that the petitioner's ap-

peal be denied and that the Commissioner's determination of deficiencies be approved.

(Signed) J. P. WENCHEL, J.H.P.
Chief Counsel, Bureau of Internal Revenue.

Of Counsel:
ALVA C. BAIRD,
Division Counsel.
JOHN H. PIGG,
Special Attorney,
Bureau of Internal Revenue.

[Endorsed]: U.S.B.T.A. Filed: April 15, 1942.
JHP:wm 4-8-42 [21]

The Tax Court of the United States

Docket No. 110050

JOHN H. SMITH,

Petitioner,

vs,

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

Clarence D. Phillips, Esq., for the petitioner.
E. A. Tonjes, Esq., for the respondent.

Harron, Judge: Respondent determined deficiencies in income tax in the amounts of $33,502.64 and $29,444.39, respectively, for the years 1938 and 1939.

Respondent added penalties to the deficiencies in the amounts of $1,675.13 and $1,472.22, under section 293(a) of the Revenue Act of 1938, for negligence in failing to report the transactions which gave rise to the deficiencies. The questions in issue are: [22]

(1) Whether petitioner realized taxable income during the years 1938 and 1939 to the extent of the difference between the purchase price and the fair market value of certain stock acquired by him pursuant to an option granted by his employer in the year 1934.

(2) Whether petitioner is liable for the 5 per cent penalty.

(3) Whether petitioner sustained an ordinary loss or a capital loss on certain units of interest in the San Juan Mining Syndicate which became worthless during the year 1939.

The returns were filed with the collector of internal revenue for the district of Oregon.

FINDINGS OF FACT

Issues (1) and (2): Petitioner resides in Portland, Oregon. After the world war, petitioner became an employee of the Western Cooperage Company, an Oregon corporation, hereinafter called Western, and has been in its employ ever since. Petitioner has been employed in different executive capacities with Western; at the present time, he is general manager of the company.

Prior to 1933, the Hawley Pulp and Paper Com-

pany, a Delaware corporation, hereinafter called Hawley, was having financial difficulties. Among its liabilities were outstanding bonds, and a bondholders' protective committee was formed. Western, at the request of the bondholders' committee, took over the management of Hawley. A reorganization committee was appointed. This committee submitted a plan of reorganization, dated [23] as of January 18, 1934, which was adopted during the year 1934. Petitioner personally took an active part in the reorganization. He interviewed many of the holders of the Hawley securities and was successful in getting a substantial amount of securities deposited under the reorganization plan.

The reorganization plan provided that Western would, at its option, continue to manage Hawley as long as it was not in default under the plan. The management, under Western, was to retire annually a certain amount of the outstanding indebtedness during each year. Compensation for management was provided for as follows: When the amount of $1,400,000 of the total indebtedness of $2,790,150 was retired, the depositary, The Bank of California, National Association, was to deliver shares of Hawley's second preferred stock and voting trust certificates of common stock, hereinafter called common stock, to Western. The amount of stock to be delivered was that number of shares which would bear the same ratio to the total shares deposited as the amount of indebtedness retired bore to the total indebtedness. There after the re-

maining shares of second preferred stock and common stock were to be delivered to Western on the same basis. There were deposited with the depositary 174,378 shares of common stock of Hawley pursuant to the reorganization plan.

In December of 1934, Watson Eastman, who was president and general manager of Western, gave a verbal option to petitioner as a reward for services rendered by petitioner prior to December 10, 1934, in connection with the reorganization of Hawley. [24]

Upon advice of counsel, Western, by corporate resolution, dated May 4, 1937, authorized the execution and delivery of a formal written option, dated as of December 10, 1934, embodying the same terms as the oral option. This resolution stated, in part, that the president of Western had given "to John H. Smith, in consideration of his services theretofore rendered in negotiating the plan of reorganization of Hawley Pulp and Paper Company and in bringing about the deposit of securities enabling the confirmation of said plan by decree of the District Federal Court of Portland, Oregon, an option", and "that the executive officers of this corporation be authorized and directed on behalf of this corporation to execute and deliver, as of the 10th day of December, 1934, to John H. Smith, a formal option substantially setting forth the option and the terms and provisions thereof as hereinbefore in this resolution recited."

Western, pursuant to the above resolution, exe-

cuted a written option as of December 10, 1934. The written option provided, inter alia, as follows:

> * * * in consideration of services rendered by John H. Smith of Portland, Oregon, hereinafter called "said Smith", prior to the date hereof, in negotiating the plan of reorganization as set forth in the reorganization indenture between Hawley Pulp and Paper Company, hereinafter called the "Hawley Company", and its depositing security holders of date January 18, 1934, and in bringing about the deposit of securities enabling the confirmation of said plan, does hereby, on this 10th day of December, 1934, grant unto the said John H. Smith, his heirs or assigns, the following several options, either one of which, or both of which, may be exercised by the said Smith, his heirs or assigns, upon compliance by him or them with the terms of the option which is being exercised by him or them; said options are expressed and conditioned as follows, to-wit: [25]
>
> * * * *
>
> OPTION B.
>
> 1. To purchase on or before January 1, 1940, at a price of $7437.70, the right to receive all common stock of the Hawley Company in excess of 100,001 shares of the common stock of the Hawley Company to be received by the Cooperage Company in the performance of its management contract referred to in said plan of reorganization.

2. This option shall be void unless exercised by the said Smith, his heirs or assigns, on or before January 1, 1940.

3. It is possible that the said Smith, his heirs or assigns, may exercise this option and that the said Cooperage Company, by reason of management defaults, may be entitled to receive only a portion of the Common Stock of the Hawley Company placed in escrow under said reorganization plan, and if such be the case then the Cooperage Company will, upon such exercise of this option and upon the written request of said Smith so to do, file with the Depositary holding said Common Stock in escrow under the terms of said reorganization plan a written notice that it has sold to said Smith, his heirs or assigns, its right to receive under said reorganization plan 74,377 shares of the Common Stock of the Hawley Company, and with said written notice the Cooperage Company will file with said depositary a written order directing the said Depositary to thereafter deliver to the Cooperage Company and said Smith, his heirs or assigns, the Common Stock of the Hawley Company held by it in escrow and which the Cooperage Company may be entitled to receive, in the proportion of six shares to the Cooperage Company and four shares to the said Smith, his heirs or assigns, until the Cooperage Company shall have received 100,001 shares and the said

Smith, his heirs or assigns, shall have received approximately 66,667 shares, and thereafter to deliver the balance of said stock of approximately 7,710 shares to the said Smith, his heirs or assigns.

4. In case this option shall be exercised by said Smith, his heirs or assigns, and if the Cooperage Company may have earned the release to it of said stock in accordance with the provisions set forth in said reorganization plan, then all such deliveries of said Common Stock shall be made by the said Depositary to said Cooperage Company and to said Smith, his heirs or assigns, in the proportion in the next preceding paragraph stated.

5. This option may be exercised at any time hereafter until January 1, 1940, by the delivery by said Smith, his heirs or assigns, to the Cooperage Company of his or their written declaration of the exercise of this option together with the option price of Seven thousand four hundred thirty-seven and 70/100 Dollars ($7437.70). [26]

On or before March 18, 1938, Western reduced the outstanding indebtedness of Hayley by the amount of $1,409,720.

Petitioner, in March of 1938, exercised his option and paid Western the amount of $11,180.70, by check dated March 21, 1938, which represented the payment of $7,437.70 for 74,377 shares of com-

mon stock at ten cents a share, and $3,743 for 3,743 shares of second preferred stock at one dollar a shares. The preferred stock is not involved in this proceeding.

Western, by order dated March 18, 1938, made demand on the depositary to deliver 50,939½ shares of Hawley common stock to Western, and 33,759 shares of such common stock to petitioner.

During the years 1938 and 1939 petitioner received shares of Hawley common stock as follows: 33,759 shares on March 19, 1938; 3,661 shares on February 3, 1939; 2,680 shares on November 1, 1939; and 6,033 shares on December 28, 1939; total number of shares received in 1939, 12,374.

On December 10, 1934, the common stock of Hawley had a market value of not more than ten cents a share.

Western, in recording the receipt of $7,437.70 from petitioner, debited cash and credited an account entitled "John H. Smith Investment". When petitioner received the stock, the same account was debited, and the Profit and Loss Account for 1938 was credited with the amount of $7,437.70. In its income tax return for the year 1938, Western reported this transaction with petitioner as resulting in a capital gain of $7,437.70, with the explanation, "Sale of our right to receive 74,377 Shares Common Stock of Hawley Pulp and Paper Company".

[27]

Petitioner did not report any income for the year 1934 on account of the receipt of the option. Pe-

titioner did not report in his returns for the years 1938 and 1939, his acquisition of the common stock of Hawley.

Respondent determined that the common stock of Hawley, received by petitioner during the years 1938 and 1939 had a fair market value at the time the stock was received in the respective amounts of $84,397.50 and $72,901.38, and that, accordingly, petitioner realized income to the extent of the excess of the fair market value over and above the price paid for the stock upon the exercise of the option.

During the years 1940 and 1941, petitioner sold approximately 31,939 shares of common stock of Hawley. Petitioner reported these sales and used ten cents a share as a cost basis in computing his gain.

The excess of the fair market value over the option price of the common stock of Hawley, received by petitioner during the taxable years, constituted income to petitioner in the respective amounts of $81,021.60 and $71,663.98.

Petitioner's failure to report income from the receipt of the Hawley stock in each taxable year was due to an honest mistake of law and was not due to negligence or an intentional disregard of respondent's regulations.

Issue (3): On July 17, 1937, petitioner purchased four units of interest in the San Juan Mining Syndicate for the total sum of $1,000. The said units of interest became worthless on or about April 25, 1939. Petitioner did not receive any money

by reason of the liquidation of this syndicate and charged off on his books as worthless all interest in the syndicate. [28]

OPINION

Issue (1). The question is whether the difference between the option price and the fair market value of the common stock acquired pursuant to the option is taxable as a gain resulting from a bona fide sale and purchase, or as compensation to petitioner for personal services. If the gain constituted compensation to petitioner, it is taxable as income in the years when the stock was received.

Respondent added the sums of $81,021.60 and $71,660.98[1] to petitioner's net income for the years 1938 and 1939, respectively, upon the theory that such amounts represented additional compensation received by petitioner in each of the taxable years. Respondent determined that these sums, which were the excess of the fair market value over the option price of the common stock acquired by petitioner pursuant to the option, were income under section 22(a) of the Revenue Act of 1938. Section 22(a) defines "gross income" as including "gains, profits, and income derived from salaries, wages, or com-

(1) This amount is the difference between the cost of 12,404 shares at 10 cents a share, and a fair market value of $72,901.38. At the hearing it was shown that the total number of shares received in 1939, at various dates, was 12,374 shares, but that the total fair market value was not other than $72,901.38, with this correction, the difference between the cost and the fair market value is $71,663.98 as stated in the findings of fact.

pensation for personal service, of whatever kind and in whatever form paid * * *". Article 22(a) (1) of Regulations 101, promulgated under the provisions of the Revenue Act of 1938, provides in part as follows:

> * * * If property is transferred by a corporation to a shareholder, or by an employer to an employee, for an amount substantially less than its fair market value, regardless of whether the transfer is in the guise of a sale or exchange, such shareholder or employee shall include in gross income the difference between the amount paid for the property and the amount of its fair market value to the extent that such difference is in the nature of (1) compensation for services rendered or to be rendered or (2) a distribution of earnings or profits taxable as a dividend, as the case may be. In computing the gain or loss from the subsequent sale of such property its basis shall be the amount paid for the property, increased by the amount of such difference included in gross income. * * * [29]

Petitioner has not contested respondent's determination of the fair market value of the stock received by petitioner during the taxable years. Therefore, if it is found that the difference between the option price and the fair market value of the stock was compensation to petitioner, respondent must be sustained.

Petitioner contends this differential was not compensation for personal services, but a gain resulting

from a bona fide purchase and sale. Petitioner has cited a number of cases in support of his contentions. These cases merely hold that under the facts of each case, the options were not given as compensation for services, but for some other reason such as to increase the employee's interest and proprietary attitude toward the employer corporation.

Respondent relies on Estate of Edward J. Connolly, 45 B. T. A. 374 (appealed CCA 6, January 15, 1942). In that case it was stated:

> The facts in the instant proceedings show that the options given to Connolly and to Anderson were for the purpose of granting them additional compensation for services already performed and currently being performed. If Connolly and Anderson upon the receipt of those options had immediately exercised them, we think it would have to be held that each received taxable income of the difference between the amount paid for the shares and their fair market value. See Edward J. Epsen, 44 B. T. A. 322. Connolly and Anderson did not, however, exercise the options during 1935. They waited until January 30, 1936, at which time the fair market value of the shares was $5 per share. Quite clearly the Hayes Body Corporation paid Connolly and Anderson no additional compensation in 1935. If the options had never been exercised the optionees would never have received any additional compensation. But when the options were exercised the company parted with shares of stock which could have been sold at $5 per share. * * *

Petitioner was instrument in consummating the reorganization plan of Hawley. Under the plan, Western would receive considerable compensation if [30] it was successful in its management of Hawley. It is indisputable that Western gave the option to petitioner as compensation for services rendered in effecting the reorganization plan of Hawley. It is so stated in the Western corporate resolution and in the option itself. Furthermore, petitioner testified that the option was given to him as compensation for such services. If petitioner had not exercised the option, Western would have received all of the Hawley common stock. When petitioner exercised his option and received the stock, Western parted with the right to receive stock which had a much greater value than the option price. Under the reasoning of the Connolly case, petitioner received compensation to the extent of the differential.

Petitioner has suggested several factual dissimilarities in this case to distinguish it from the Connolly case, which are not material. The basic facts are that petitioner was given an option as compensation for services and that he realized gains in the taxable years pursuant to the exercise of this option. It is a settled rule that when an option is given to an employee as compensation for services, rendered or to be rendered, the gain realized through the exercise of such option is taxable as realized compensation. Albert Russel Erskine, 26 B. T. A. 147; Edward J. Epsen, supra; and Estate of Edward J. Connolly, supra.

Accordingly, it is held that the difference between the option price and the fair market value of such common stock acquired by petitioner pursuant to the option was taxable as compensation received by petitioner in the taxable years. [31]

Issue (2). Respondent has imposed the negligence penalty under section 293(a) of the Revenue Act of 1938[2], because of petitioner's failure to report in his return income realized from a transaction discussed under Issue (1). The statute is so worded that the taxpayer is allowed to show that his omission in his tax return was without intent to defraud and was without intentional disregard of rules and regulations. If the taxpayer shows that there has not been any negligence or an intentional disregard of rules and regulations, he may establish that he is not liable for the penalty.

The transaction between Western and petitioner was of such nature that the effect in the taxable year upon petitioner's income tax liability involved a construction of law which in and of itself is difficult. We are satisfied from the record that peti-

(2) Sec. 293. Additions to the Tax in Case of Deficiency.

(a) Negligence.—If any part of any deficiency is due to negligence, or intentional disregard of rules and regulations but without intent to defraud, 5 per centum of the total amount of the deficiency (in addition to such deficiency) shall be assessed, collected, and paid in the same manner as if it were a deficiency, except that the provisions of section 272(i), relating to the prorating of a deficiency and of section 292, relating to interest on deficiencies, shall not be applicable.

tioner's failure to report the excess of the fair market value of the stock over the option price as income was due [32] to an honest misunderstanding of law and not to negligence or intentional disregard of regulations.

Western treated the transaction as a sale and not as compensation. Petitioner, under a misunderstanding of the law, took the same view. It is held that the penalty provided for under section 293(a) should not be imposed upon the petitioner.

Issue (3). The question is whether the syndicate units which had been purchased on or about July 17, 1937, and which became worthless in the year 1939 were "securities" as defined in section 23(g)(3) of the Revenue Act of 1938.[3] Respondent determined that the interests in the syndicate were tantamount to shares of stock, and that they were capital assets under section 117(a). Respondent held then that when the interests in the syndicate became worthless in 1939, the allowable loss was limited by the provisions of section 117, the loss being considered as a loss from the sale or exchange of a capital asset, under 23(g)(2).[3] Since they had been held for

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(3) Sec. 23. Deductions From Gross Income.

In computing net income there shall be allowed as deductions:

(g) Capital Losses.—

* * * * *

(2) Securities Becoming Worthless.—If any securities (as defined in paragraph (3) of this subsection) become worthless during the taxable year and are capital assets, the loss resulting therefrom shall, for the purposes of this title, be considered as a loss from the sale

more than two years, [33] respondent held that the allowable loss was 50 percent or $500, under section 117(b) Petitioner in his return for the year 1939 deducted the amount of $666.66 as a capital loss. Petitioner now contends that he is entitled to deduct the entire amount of the cost of the interests, as an ordinary loss under section 23(a)(2). Petitioner claims that he has overpaid the tax because of an understatement of the loss.

In our opinion respondent's determination must be sustained under section 23(g) (2). Petitioner has failed to show that the syndicate was not a "corporation" within the meaning of that term as defined by section 901(a) (2).[4] The term corporation includes associations. It is a question of fact whether or not a syndicate is a "corporation" for purposes of the revenue act. Petitioner has not submitted any evidence relating to the nature of the organization of the San Juan Mining Syndicate. It is impossible, for failure of proof, to hold that this syndicate was not an association or a corporation, under the statute, in the nature of its structure. Petitioner

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or exchange, on the last day of such taxable year, of capital assets.

(3) Definition of Securities.—As usual in this subsection the term "securities" means (A) shares of stock in a corporation, and (B) rights to subscribe for or to receive such shares.

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[4] Sec. 901. Definitions.

(a) When used in this Act—

(2) The term "corporation" includes associations, joint-stock companies, and insurance companies.

has failed to meet his burden of proof on this question.

It is held that the loss deduction is limited to $500 under section 23(g)(2).

Decision will be entered under Rule 50.

Entered Feb 26 1943 [34]

The Tax Court of the United States
Washington

Docket No. 110050

JOHN H. SMITH,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DECISION

Pursuant to the Memorandum Findings of Fact and Opinion entered on February 26, 1943, respondent, on March 18, 1943, filed recomputation of the deficiency under Rule 50. Upon due notice of a hearing on the recomputation, petitioner did not file objection thereto. Accordingly, it is

Ordered and Decided: That there are deficiencies in income tax liability for the years 1938 and 1939 in

the respective amounts of $33,502.64 and $29,446.16, and that no penalties are due.

[Seal] (Signed) MARION J. HARRON
Judge

Entered Apr-7-1943.
evd— [35]

[Stamped] Received Jun 9—1943 The Tax Court of the U.S.A.

[Endorsed]: Filed Oct. 14, 1942.

United States Board of Tax Appeals
[Title of Cause.]

REPORTER'S MINUTES

Hearing at Portland, Oregon,
On the 17th day of September, 1942,
at 7:50 P. M.

The above entitled proceeding came on for hearing on the 17th day of September, 1942, before the Honorable Marion J. Harron, Member of the United States Board of Tax Appeals, at Portland, Oregon, pursuant to notice of hearing heretofore given, whereupon the following proceedings were had, to-wit:

Appearances:

C. D. PHILLIPS, Esq.,
805 Electric Building, Portland, Oregon
appearing on behalf of the Petitioner.

E. A. TONJES, Esq.,
appearing on behalf of the Commissioner of Internal Revenue, Respondent. [36]

PROCEEDINGS

The Member: Docket No. 110050, John H. Smith. State your appearances. Are you ready?

Mr. Phillips: The Petitioner is ready, your Honor.

Mr. Tonjes: Respondent is ready.

The Member: Then state your appearances, will you please, to the reporter.

Mr. Phillips: Clarence D. Phillips, attorney for the Petitioner.

Mr. Tonjes: E. A. Tonjes (spelling), appears for the Respondent.

The Member: The Respondent has determined the deficiency in income tax in 1938 in the amount of $35,502.64 and in 1939 in the amount of $29,044.39, and a penalty has been determined in addition. What is the question in the case, Mr. Phillips?

Mr. Phillips: If your Honor please, we have two issues in the case. The first has developed around an option. And I assume that your Honor wants a little background in the opening statement.

The Member: No, I don't think we have time for that. I want to know what the question is.

Mr. Phillips: The question is, your Honor, whether or not $74,377 shares of stock were earned by the Western—of stock of the Hawley Pulp & Paper Company, which the [38] Western Cooperage Company acquired right to receive in connection with the reorganization of the Hawley Pulp & Paper Company. This is common stock. They also acquired the right to acquire a certain second preferred stock. And mentioned in this connection, this com-

mon stock was the matter of oral option to Mr. Smith of the Western Conperage Company in December of 1934. In 1937 that oral option was made the subject of a written option agreement, to be dated January 4, 1940. Mr. Smith exercised the option on January, 1938, and paid for all of the common stock he was entitled to receive under that option. The option price on the common stock was 10c, which was the reflected market price, or, at least in excess of the market price as of December 10, 1934. The Commissioner contends in this case that Mr. Smith received some 33,000 shares in 1938 at the option price of 10c a share and in 1939 received the balance of it, is their contention, and that they claimed Mr. Smith received income to the extent of the difference between the market price in 1938 and 1939 respectively. The other issue was a small issue with respect to a loss in interest in the San Juan Mining Syndicate, in which Mr. Smith purchased an interest in 1937 and this syndicate went out of business, they contend, they liquidated in 1939, with no recovery to parties of the syndicate in 1939, and in that return he asked for a loss on a capital loss basis and it was disallowed; as a matter of fact, we have asked in this [39] appeal that he be allowed a full loss on the basis of an ordinary business loss.

The Member: Do the Respondents have a statement?

Mr. Tonjes: I don't think there is any further statement on my part, your Honor. Those are the issues as I understand them.

The Member: All right. Will you proceed.

Mr. Phillips: Are you ready for the witnesses?

The Member: Yes.

Mr. Phillips: Call Mr. Smith. You will sit over here, Mr. Smith, and be sworn, please.

The Clerk: State your name for the reporter, please.

The Witness: John H. Smith.

JOHN H. SMITH

was called as a witness for and on behalf of himself, and having been first duly sworn, was examined and testified as follows:

Direct Examination

By Mr. Phillips:

Q. Your name is John H. Smith?

A. It is, and I believe in these tax reports it is recorded as John H. Smith, Jr., for the matter of continuity.

Q. John H. Smith, Jr., when referring to it, when it is referred to in any of these documents or records, is the [40] same as John H. Smith?

A. Correct.

Q. Where do you reside, Mr. Smith?

A. At 11476 River Road, Portland, Oregon.

Q. And how long have you lived in Portland?

A. Since 1919.

Q. What is your present occupation?

A. President of the Hawley Pulp & Paper Company and general manager of the Western Cooperage Company.

Q. Now, in order to get a little background of

(Testimony of John H. Smith.)

your experience in the event subsequently you might need some qualification and experience, will you tell us what schools you have attended, first?

A. How far back should I go?

Q. Well, just briefly, you might tell us where you went to grade school and high school, if any, and so forth.

A. I went to grade school at Astoria, Oregon, the place of my birth. I went to high school at what was known as a prep school named Troop in Pasadena, California, and also a very short time to the high school in Astoria and then also went to college in California, as far as the college was concerned.

Q. You are a graduate of California?

A. No. While I was in there and before graduating I left because of the last World War. [41]

Q. Then you entered the war service, and after the war service what has been your business experience?

A. After the World War I entered the employment of the Western Cooperage Company and have been with them ever since.

Q. What is your capacity, what was it when you first entered their employment?

A. As timber manager.

Q. Did you have any particular locality or in general?

A. In general, in most of their timber interests was in Pasco County, Oregon, which is the same county Astoria is located in.

(Testimony of John H. Smith.)

Q. So that since that time, have you had any other capacity since that time with the Western Cooperage Company?

A. Yes, I have, as Oregon manager and assistant general manager and general engineer to the present time.

Q. At the present time you are general engineer?

A. Yes, sir.

Q. Are you also familiar with the set-up of the Oregon Pulp & Paper Company, that is, the corporation that issued stock which is in question in this proceeding? A. I am.

Q. And when did you first have knowledge of a connection with them?

A. My first knowledge of Hawley was very superficial knowledge and just in a general way for many years past. The [42] first intimate knowledge would be in,—early in 1932 when there was, I believe that was about the date, when there was a bond committee formed of which my immediate superior, Mr. Watson Eastman was chairman and he compared and cooperated with me on various subjects at that time.

Q. Now, that was in 1932? A. As I recall.

Q. With respect to Hawley Pulp & Paper Company at that time and just prior to that time, do you know whether they were having any financial difficulties?

A. Yes. They were, in spite of the fact the committee,—the bond committee was organized.

Q. Then the bond committee, after organization,

(Testimony of John H. Smith.)

did they take control or develop the Hawley Pulp & Paper for operation purposes?

A. The bond committee I am referring to did not take control. They investigated the files of the company and made certain recommendations and later on there was another bond committee organized. The first committee did not solve the financial difficulties or difficulty of the company.

Q. At that time was the Western Cooperage Company interested in any way financially in the Hawley Pulp & Paper Company?

A. At that time the Western Cooperage Company had some Hawley bonds, as I recollect, some $27,000, par value, that [43] was the only connection with it.

Q. You mentioned Mr. Watson Eastman. Did he personally have some financial interest in the Hawley's?

A. He had no,—he had no interest except with the bond committee, he was on the bond committee and that was all, as I recall.

Q. Now, the Western Cooperage Company, will you tell the Board what is the business of the Western Cooperage Company, what Mr. Eastman has to do with respect to the Western Cooperage?

A. Watson Eastman was president and general manager of the Western Cooperage Company.

Q. Will you explain briefly what sort of a corporation the Western Cooperage Company is, that is, with respect to the stock, whether it is rather

(Testimony of John H. Smith.)

closely held or a closed or open organization, or whatever it is?

A. The Western Cooperage Company is an Oregon organization with the stock rather closely held. I would say that at least 80% of it is held in two families and virtually a 100% held in the same two families or the employees of the Western Cooperage Company.

Q. Now, from 1932 up and through the remainder of the life of Watson Eastman, will you state briefly what part did he play in the management of the Western Cooperage Company?

A. Will you repeat that question again, please?

[44]

Q. I say, from 1932 on up through to the time of his death, what part did Major Watson Eastman play in the management of the affairs of the Western Cooperage Company?

A. He was president and general manager.

Q. And did they have occasion to conduct their affairs similarly with regular board meetings or was their business transacted somewhat informally?

A. Why, I would say the business was transacted informally, in that they regularly held an annual meeting with infrequent board meetings. The board meetings being held only when there was some particular urgency to,—such as the sale of some real estate or something of that sort which had to be attended to with the board meetings and probably they would not average over two a year, other than the annual meeting.

(Testimony of John H. Smith.)

Q. And at the board meetings, then, who actually ran the affairs of the corporation, besides the board meetings?

A. Watson Eastman.

Q. Major Watson Eastman. Now, with respect to the Hawley reorganization work, will you explain to the Board what transpired chronologically with respect to the Hawley Pulp & Paper Company from the time you know of it in 1932 up until 1934?

A. There was a bond protective committee organized that, as I recall, as early as 1932, it might be slightly earlier, such as late in 1931. What committee investigated [45] the affairs of the Hawley Pulp & Paper Company. Made certain recommendations which were adopted and dissolved. Subsequent to their dissolving the Hawley Pulp & Paper Company, they got in still worse financial condition and passed their bond interest so that another bond holders' protective committee was organized and functioned for a considerable time. I—in excess of six months. And I think that probably considerable in excess of six months. They studied the affairs of the corporation and they finally proposed a reorganization under 77B, and that reorganization was eventually adopted, but during that time this bondholders' protective committee advised the Western Cooperage Company to take over the management of the Hawley Pulp & Paper Company and that was done in December of 1932 and continued until subsequent to 1934.

Q. Now, right in there, for the purpose of the

(Testimony of John H. Smith.)

Board, will you outline briefly the financial structure of the Hawley Pulp & Paper Company at that time with respect to their bonds, their notes and stocks?

A. At the time——

Q. (Interposing) When you say at that time, let us take that and peg it down to a date and see when the Western Cooperage Company took over.

A. (Continuing) ——at the time when they took over, when the Western Cooperage Company took over in December of 1932, the Hawley Pulp & Paper Company had outstanding bonds, [46] as I recall, of $2,127,500, of which interest had accrued and was in default. I forget the amount of the interest. They had a note outstanding of $500,000, on which the interest had accrued and had passed due date and so I would say the note was in default. It had $200,000 of 7% preferred stock and 8,000 shares of 6, 6% preferred stock, and 200,000 shares of common stock.

Q. The 8,000 shares is the second preferred?

A. The second preferred, the 6%.

Q. Now, in 1932, prior to the time the Hawley Pulp & Paper Company took over the management of the Hawley Pulp & Paper Company, or I mean the Western Cooperage Company took over the management of the Hawley Pulp & Paper Company, will you state whether or not they took over that management of voluntarily, you might say, or rather involuntarily took it over?

A. Well, I can't say whether it was voluntary

(Testimony of John H. Smith.)

or involuntary. I would have to recite what happened.

Q. Well, recite what happened, then.

A. The Western Cooperage Company was requested to take over the management and refused to do so on the basis that we did not have enough financial interest to make it worth our consideration. We were still requested, and that request was pressed until finally, to bring the matter to a head, we stipulated the conditions on which we would take over the [47] management, thinking the conditions we stipulated were so severe that they would end the matter by their not accepting, but instead of that our conditions were accepted and we took over the management.

Q. Now, through 1933, then, were plans being formulated for a reorganizing of this organization, the Hawley Pulp & Paper Company?

A. They were.

Q. And were they culminated in a plan of reorganization eventually?

A. They were.

Q. And about what time did that formulation itself develop into a plan of reorganization?

A. The plan, as I recall it, is dated January 1, 1934. However, you said culminated in a plan.

Q. Well, I don't mean by that approved by the company or approved by the security holders, a plan—the formulation of a plan?

A. I would say,—I would say that the plan culminated in that it received the approval of the

(Testimony of John H. Smith.)

bondholders committee, shortly after January 1, 1934, excepting there was a string on it. The bondholders committee was in disagreement and—but they all agreed that that plan was the best plan of the various things talked about, unless the company could be sold and the bondholders should get what they could on the theory [48] they were the senior security.

Mr. Phillips: If your Honor please, we will offer in evidence at this time for identification the copy of the reorganization indentures, which include a copy of the plan of reorganization.

The Member: All right. There is no objection?

Mr. Tonjes: No objection.

Mr. Phillips: It is just preliminary. It has not a direct connection with the issues but I think it is quite explanatory and might be useful.

The Member: All right, mark it Petitioner's Exhibit 1.

(Reorganization indentures referred to was marked Petitioner's Exhibit No. 1 for identification.)

(Testimony of John H. Smith.)

PETITIONER'S EXHIBIT No. 1.

Reorganization Indenture
(Including Deposit Agreements)

Between
Hawley Pulp and Paper Company
and
Depositing Security Holders
of
Hawley Pulp and Paper Company

Dated January 18, 1934

Providing for a reorganization of the Hawley Pulp and Paper Company.

Reorganization Indenture

This Reorganization Indenture, dated as of January 18, 1934, between Hawley Pulp and Paper Company, a corporation of Delaware, hereinafter called the "Company", and such holders of its securities, as hereinafter described, as shall become parties to this agreement in the manner hereinafter provided, and the holders from time to time of Deposit Receipts issued pursuant to the consummation of the plan of reorganization as hereinafter provided: Witnesseth:

First, Whereas, the Board of Directors of the Company did, on June 30, 1933, deem it to be in the best interest of the Company and its security hold-

(Testimony of John H. Smith.)

Petitioner's Exhibit No. 1—(Continued)

ers to evolve and consummate some plan of financial reorganization, and to that end did, by resolution appoint a reorganization committee, which as presently constituted, is as follows:

Isaac D. Hunt and E. S. Collins, of Portland, Oregon, representing the bondholders,

W. Lair Thompson, of Portland, Oregon, representing the noteholder,

A. S. Kerry of Seattle, Washington, representing the stockholders, and

Watson Eastman, of Portland, representing the management;

and,

Second, Whereas, the said reorganization committee did, on January 18, 1934, submit to the Board of Directors of said Company the following "plan" of reorganization:

Report of the Reorganization Committee
of
Hawley Pulp and Paper Company
Portland, Oregon, January 18, 1934.

To the Security Holders of Hawley Pulp and Paper Company:

The undersigned reorganization committee, consisting of Isaac D. Hunt and E. S. Collins, representing the bondholders, W. Lair Thompson, representing the note holder, A. S. Kerry, representing the stockholders, and Watson Eastman, representing the management, as appointed by the Board of Directors of Hawley Pulp and Paper Company, hereinafter called "said company", recommends the

(Testimony of John H. Smith.)

Petitioner's Exhibit No. 1—(Continued)

following plan of reorganization:

1. Description of Securities: The bonds outstanding under the mortgage and deed of trust, hereinafter called "said mortgage", from said company to The Bank of California, National Association, Trustee, of date July 1, 1926, note and stock liability of said company to be considered in reorganization is as follows:

6% First Mortgage Bonds due 7/1/46	$2,127,500.00	
Interest accrued to 1/1/34	127,650.00	$2,255,150.00
Hereinafter called "Bonds"		
7% Note due 7/1/34	500,000.00	
Interest accrued to 1/1/34	35,000.00	535,000.00
Hereinafter called "Note"		
20,000 shares First Preferred $7 Cumulative no par stock	2,000,000.00	
Cumulative dividends to 1/1/34	420,000.00	2,420,000.00
Hereinafter called "First Preferred Stock"		
8000 shares Second Preferred Cumulative no par stock, hereinafter called "Second Preferred Stock"		
200,000 shares no par Common Stock, hereinafter called "Common Stock"		

2. Voting Trust of First Preferred Stock: By reason of default in the payment of dividends on the First Preferred Stock, the voting power of said company in the matter of the election of a Board of Directors is exclusively lodged in the First Preferred Stock, and will continue in the First Preferred Stock until all cumulative dividends on the First Preferred Stock have been declared and paid,

(Testimony of John H. Smith.)

Petitioner's Exhibit No. 1—(Continued)

or set apart for payment. In order to control the election of a Board of Directors as contemplated under this plan of reorganization, it is recommended that at least a majority of the First Preferred Stock be placed in a voting trust under the terms of which trust the members of the Permanent First Preferred Stockholders' Committee, as trustees will elect directors of said company as recommended by the several committees as hereinafter provided.

3. Permanent Bondholders' Committee: After consultation with the bondholders, the following permanent bondholders' committee is appointed:

J. C. Ainsworth, Portland, Oregon
L. R. Banks, Portland, Oregon
E. S. Collins, Portland, Oregon
Issac D. Hunt, Portland, Oregon
A. S. Kerry, Seattle, Washington

4. Permanent Noteholder Committee: After consultation with the noteholder, the following permanent noteholder committee is appointed:

M. P. Griffiths, Seattle, Washington
Geo. Leib, San Francisco, California
W. Lair Thompson, Portland, Oregon

5. Permanent First Preferred Stockholders' Committee: After consultation with the First Preferred Stockholders, the following permanent First Preferred stockholders' committee is appointed:

J. R. Bowles, Portland, Oregon

(Testimony of John H. Smith.)

Petitioner's Exhibit No. 1—(Continued)

Arthur Devers, Portland, Oregon
Franklin T. Griffith, Portland, Oregon
Fred Gronnert, Portland, Oregon
Jos. T. Peters, Portland, Oregon

6. Permanent Second Preferred and Common Stockholders' Committee: After consultation with the Second Preferred and Common stockholders, the following permanent Second Preferred and Common Stockholders' committee is appointed:

J. H. Smith, Portland, Oregon
Eugene Bashore, San Francisco, California
T. Henry Boyd, Portland, Oregon

7. Perpetuation of Committees: In case of any vacancy in any of the above named committees by reason of death, resignation or otherwise, such vacancy in each of said committees, except as to the permanent noteholder committee wherein a vacancy shall be filled by election of any person by the surviving members of such committee, shall be filled by election by the surviving members of such committee from the same class of security holders which the committee is representing; each of such committees as hereby constituted, or as same may be constituted in election by survivors, shall continue until retirement as hereinafter provided; the action of each committee shall be governed by a majority vote of the membership of the committee as then constituted.

8. Board of Directors: The affairs of said com-

(Testimony of John H. Smith.)

Petitioner's Exhibit No. 1—(Continued)

pany shall be handled by a Board of seven Directors, who shall appoint all officers of said company.

The said voting trustees of the First Preferred stock, under the terms of the said voting trust agreement, shall elect Directors as follows:

(A) Four Directors to be nominated by said permanent bondholders' committee;

(B) One Director to be nominated by said permanent noteholder committee;

(C) One Director to be nominated by said permanent First Preferred Stockholders' committee;

(D) One Director to be nominated by said permanent Second Preferred and Common stockholders' committee.

If and when the bondholders' committee shall retire as hereinafter provided, then the said Board of Directors shall be elected by said voting trustee as follows:

(A) Four Directors to be nominated by said permanent noteholder committee;

(B) Two Directors to be nominated by said permanent First Preferred stockholders' committee;

(C) One Director to be nominated by said permanent Second Preferred and Common stockholders' committee.

If and when said permanent noteholder committee shall retire as hereinafter provided, then the

(Testimony of John H. Smith.)

Petitioner's Exhibit No. 1—(Continued)

said Board of Directors shall be elected by said voting trustees as follows:—

(A) Four Directors to be nominated by said permanent First Preferred stockholders' committee;

(B) Three Directors to be nominated by said permanent Second Preferred and Common stockholders' committee.

If and when all accrued and accumulated dividends upon the First Preferred stock shall have been declared and paid, or set apart for payment, then the said voting trust agreement shall terminate and the Board of Directors shall be elected by the stockholders who may then be entitled to vote for said Board of Directors.

9. Plan of Reorganization: It is proposed to preserve, unchanged, the capital structure of said company, and through the existing committees formed to represent the various classes of securities to obtain deposits of these securities for the purpose of modifying the terms and conditions thereof, as follows:

(A) Each of said bonds shall accrue interest at 6% per annum to January 1, 1934, and such interest shall be paid at the maturity of said bond; thereafter, and until December 31, 1938, each of said bonds shall accrue interest only at the rate of 4% per annum, and such interest shall be contingently paid in accord-

(Testimony of John H. Smith.)

Petitioner's Exhibit No. 1—(Continued)

ance with the provisions of sub-paragraph (E) of this paragraph 9; prior to January 1, 1939, no default under said mortgage (1) in the payment of bond interest, (2) in the maintenance of sinking funds, (3) in the sale of capital assets in accordance with the provisions of sub-paragraph (F) of this paragraph, and/or (4) in the use or disbursement of insurance moneys in accordance with the provisions of sub-paragraph (G) of this paragraph, shall be enforcible; the action of the bondholders in waiving the provisions of said bonds and of said mortgage as in this sub-paragraph hereinbefore provided, shall in no way prejudice or affect the rights of said bondholders under any other provision of said bonds or said mortgage, and the bondholders, by virtue of consenting to the foregoing changes in the provisions of said bonds and said mortgage, shall not be held to have otherwise waived any rights which they may heretofore have had, now have, or hereafter have as to priority of their lien upon the assets described in said mortgage, and especially, but not exclusively, as to priority of any lien which may result from the interpretation and/or construction of the terms and provisions of paragraph "Eleventh" of said mortgage describing the properties covered by said mortgage and Section 2 of Article VIII of said mortgage; on and after January 1, 1939, all

(Testimony of John H. Smith.)

Petitioner's Exhibit No. 1—(Continued)

provisions of said mortgage shall again be operative, and the said mortgage shall thereafter be construed, interpreted and acted upon by the trustee thereunder, and by all other parties in interest, as though no default had existed thereunder prior to January 1, 1939.

(B) Said note shall be extended to mature on January 1, 1943, and shall accrue interest at the rate of 7% per annum to January 1, 1934, to be paid at maturity of said note; said note shall accrue interest from January 1, 1934, to December 31, 1938, at the rate of 3% per annum, to be paid in accordance with the provisions of sub-paragraph (E) of this paragraph; after December 31, 1938, said note shall accrue interest at the rate of 6% per annum, to be paid in accordance with the provisions of sub-paragraph (E) of this paragraph; in the event of any default in carrying out this plan under which the holders of said bonds shall be enabled to enforce the lien of said bonds against the properties covered by said mortgage, then the same default shall mature said note and enable the holders of said note, at their option, to enforce any rights or remedies which they may have for the collection of said note.

(C) Dividends upon the First Preferred stock at the rate of $7.00 per share per annum shall accrue and accumulate to January 1, 1934, and from January 1, 1934 to December 31, 1938,

(Testimony of John H. Smith.)

Petitioner's Exhibit No. 1—(Continued)

all dividend requirements upon said First Preferred stock shall be waived;

(D) All dividend requirements on Second Preferred stock prior to January 1, 1939, shall be waived;

(E) So long as any bonds may be outstanding, operating expenses and taxes for each year shall be paid, the plant shall be adequately maintained, and, in addition to the cost of such maintenance, the management shall provide for each calendar year sufficient "available funds" to purchase and retire $200,000.00 par value of bonds during each of the years 1934, 1935, 1936, 1937 and 1938, and $135,000.00 par value of bonds during each year subsequent to 1938.

Definitions:

1. The term "retirement fund" shall mean the depreciation charges of the company in each year as shown by the certified audit of that year, which in no event shall be less than such charges for the year 1932, to-wit, the sum of $279,404.48.

2. The term "available funds" shall mean the sum in any year of the "retirement fund" for that year and the net operating profit of that year.

The "retirement fund" of any year shall be used only for the purchase and retirement of bonds until all bonds may be retired, thereafter

(Testimony of John H. Smith.)

Petitioner's Exhibit No. 1—(Continued)

for the payment and retirement of said note, and thereafter for the payment of accumulated and accruing dividends upon the First Preferred stock.

Interest on the bonds or note, if and when paid by order of the Board of Directors, shall only be paid out of the "available funds" produced in any year in excess of the "retirement fund"; provided that if such excess funds shall be insufficient in any year to pay 66 2/3% of the face of all bond coupons of the same date of maturity, then such excess funds as may be insufficient to pay 66 2/3% of the face of all bond coupons of equal maturity shall be held by the Board of Directors in reserve to the applied in future payment of such coupons if and when additional excess funds may be available to pay such coupons; it is intended to provide hereby that no payment in a less amount than 66 2/3% of the face value of a coupon shall be made upon any coupon which represents the accrual of bond interest from January 1, 1934, to December 31, 1938.

The amount of the "available funds" for any year in excess of the "retirement fund" for that year shall be ultimately applied by the Board of Directors as follows:

First. For paying bond interest which may have accumulated subsequent to January 1, 1934;

(Testimony of John H. Smith.)

Petitioner's Exhibit No. 1—(Continued)

Second. For paying note interest which may have accumulated subsequent to January 1, 1934;

Third. For the purchase and retirement of bonds and note principal in the proportion of 81% par value of bonds and 19% par value of note.

After the said purchase and retirement of bonds of the par value of $1,000,000.00, then the amount of the "available funds" for any year in excess of the "retirement fund" for that year shall be applied by the Board of Directors as follows:

First. For paying bond interest which may have accumulated subsequent to January 1, 1934;

Second. For paying note interest which may have accumulated subsequent to January 1, 1934;

Third. For the purchase and retirement of bonds and note principal on a pro rata basis according to the par value of the then outstanding bonds and the face value of the then unpaid principal of said note.

Anything herein to the contrary notwithstanding, a majority of the members of the Board of Directors representing the superior then outstanding securities may, in their discretion, divert any part or all of such "available funds", inclusive of the "retirement fund",

(Testimony of John H. Smith.)

Petitioner's Exhibit No. 1—(Continued)

to capital plant additions, capital plant improvements and/or capital plant betterments.

The management shall always maintain the current net assets of the corporation in at least the sum of $500,000.00, and failure so to do shall be a default hereunder on the part of the management.

In case of dispute between the Board of Directors and the management as to what constitutes reasonably adequate plant maintenance, the disputed question shall be submitted to the final decision of a person experienced in the operation of paper mills to be appointed by agreement of the Board of Directors and the management; in case the Board of Directors and the management cannot agree upon such appointment, then the Board of Directors shall appoint such a person, the management shall appoint such a person, and said two appointees shall appoint a third such person; the three persons so appointed shall constitute a board of arbitration, and the decision of a majority of said board shall be final and conclusive in the premises. If the said person appointed by agreement of the Board of Directors and the management, or if said board of arbitration shall find that the plant has not been reasonably adequately maintained, he or it shall further find the sum necessary to be expended to place the plant in a condition of reasonably adequate

(Testimony of John H. Smith.)

Petitioner's Exhibit No. 1—(Continued)

maintenance; if, after deducting such sum, the management has not produced sufficient "available funds" to purchase the par value of bonds as heretofore in this paragraph provided, the Board of Directors may declare a default on the part of the management and, if such default shall not, within ninety (90) days after notice to the management thereof, be adequately cured according to the judgment of a majority of the Board of Directors representing the bondholders, then the Board of Directors shall, at the direction of a majority of the Directors representing the bondholders, discontinue the services of the management.

"(F) The management may, with the consent of the Board of Directors, call any capital assets provided that the proceeds of such sale shall be used for replacements and/or improvements to be subject to the lien of the bonds, or

First, to the purchase and retirement of all bonds;

Second, to the retirement of all of said note. Hereafter, and until December 31, 1938, regardless of any default in said mortgage as waived under sub-paragraph (A) hereof, the company may use and/or dispose of any standing timber of the company upon the purchase and delivery to the trustee under said mortgage, for cancellation, such outstanding bonds as in the aggre-

(Testimony of John H. Smith.)

Petitioner's Exhibit No. 1—(Continued)

gate of par value shall be equal to the aggregate of stumpage value of such timber so used or disposed of; said stumpage values shall be the values as set forth in Section 2 of Article IV of said mortgage.

(G) Any and all moneys received by the company in liquidation of any claim for loss under any fire insurance policy, shall, until December 31, 1938, be applied by the company, under the direction of its Board of Directors, either in the replacement of the property destroyed, or

First, to the purchase and retirement of all bonds; and,

Second, to the retirement of all of said note.

The purchase and cancellation of bonds under the provisions of this sub-paragraph (G), and/or under sub-paragraph (F) hereof, shall not be considered as a credit to the management in determining its default hereunder.

(H) If and when bonds are to be purchased and cancelled under the terms of sub-paragraph (E) hereof, under the terms of sub-paragraph (F) hereof, and/or under the terms of sub-paragraph (G) hereof, notice thereof, published once a week for four successive weeks immediately prior to the purchase of said bonds in a newspaper of general circulation, published in each of the cities of Seattle, Portland, San Francisco and Los Angeles, shall be given

(Testimony of John H. Smith.)

Petitioner's Exhibit No. 1—(Continued)

inviting offers for sale of bonds. Offers submitted shall be opened in the presence of the Board of Directors, and such offers may be accepted or rejected in the discretion of the Board of Directors, provided that only the lowest sale price shall be accepted.

(I) After the bonds have been fully retired, the permanent bondholders' committee shall retire.

(J) After the indebtedness to the noteholder has been fully paid, the permanent noteholder committee shall retire.

(K) Upon the declaration, payment, or setting apart of all accrued and accumulated dividends on the First Preferred stock, the permanent First Preferred stockholders' committee and the permanent Second Preferred and Common stockholders' committee shall retire.

(L) Not less than 85% of the voting trust certificates of Common stock, and not less than 85% of the Second Preferred stock shall be deposited in escrow with the Depositary to be selected by the Board of Directors; if, as and when $1,400,000.00 par value of said outstanding indebtedness, consisting of said bonds and said notes, shall have been purchased and retired under the present management, as contemplated by sub-paragraphs (E), (F) and (G) hereof, then the said Depositary shall deliver to the present management such a number

(Testimony of John H. Smith.)

Petitioner's Exhibit No. 1—(Continued)

of shares of said Second Preferred stock and/or voting trust certificates of Common stock as shall bear the same ratio to the total number of shares of Second Preferred stock and voting trust certificates of Common stock so deposited in escrow as said amount of $1,400,000.00 of said retired indebtedness shall bear to $2,790,150.00; thereafter, the said Depositary shall annually deliver to the management such a number of shares of said Second Preferred stock and/or voting trust certificates of Common stock as shall bear the same ratio to the total number of shares of Second Preferred stock and voting trust certificates of Common stock so deposited in escrow as the amount of any annual retirement of par value of bonds and principal of note under the provisions of subparagraphs (E), (F) and (G) hereof shall bear to $2,790,150.00; provided, however, that the Second Preferred stock shall be first delivered.

Should said management so manage the affairs of the corporation that the management is unable to provide "available funds" as hereinbefore provided for the purchase and retirement of $200,000.00 par value of bonds during each of the years 1934, 1935, 1936, 1937 and 1938, and/or after 1938 shall be unable to provide for each current year a sum sufficient to purchase and retire $135,000.00 par value bonds

(Testimony of John H. Smith.)

Petitioner's Exhibit No. 1—(Continued)

and to pay the current interest upon the outstanding bonds and note, then the said Depositary, upon written notice from the Board of Directors to the Depositary and management of such default, and upon the continuance of such default for a period of ninety (90) days after such notice, shall, at the direction of a majority of the members of the Board of Directors representing the superior then outstanding securities, either—

1. Continue to hold said Second Preferred stock and voting trust certificates of Common stock for ultimate use or disposal in the negotiation and consummation of any plan of successor management; or,

2. Deliver said Second Preferred stock and voting trust certificates of Common stock to the purchaser of the properties of the company at an execution sale held under the foreclosure of said mortgage and deed of trust.

(M) Failure to provide available funds as above provided shall give the Board of Directors authority to change the present or any future management; provided, however, if the management shall have provided available funds in excess of the requirements above stated for any one year, then in any such case such excess shall be considered as a credit to the management for any year thereafter in

(Testimony of John H. Smith.)

Petitioner's Exhibit No. 1—(Continued)

which it may be unable to provide for such annual retirements.

(N) The "management," as that term is used in this plan, is presently the Western Cooperage Company, a corporation of Oregon, and said corporation shall, at its option, continue in said management so long as it shall not be in default hereunder; if, upon default of the management, as herein provided, the Board of Directors shall remove the management, or if the management shall resign its management, then and in either of said events the defaulting or resigning management shall have no voice in the creation of a succeeding management which shall be created solely by resolution of the then Board of Directors. If, at any time, the then existing management and the Board of Directors shall agree upon other management to be substituted for the then management, then and in that event such management as so agreed upon shall succeed to the management under this plan.

10. Effect of Default of Management: In case the management shall default in providing "available funds" as hereinbefore provided for the retirement of debt or the payment of interest or dividends, then this plan shall continue or terminate in the discretion of a majority of the members of the Board of Directors representing the superior then outstanding securities; if the Board of Directors

(Testimony of John H. Smith.)

Petitioner's Exhibit No. 1—(Continued)

shall decide to terminate this plan; then the Second Preferred stock and voting trust certificates of Common stock shall be delivered as hereinbefore provided in case of default of the management, and all other securities deposited hereunder shall be freed from any change in terms or conditions thereof resulting by reason of deposit hereunder.

11. Procedure for Carrying Out the Plan: Security holders are requested to deposit their securities with the depositary hereinafter named, and it is recommended that the Hawley Pulp and Paper Company employ Blyth & Co., Inc., to assist in the presentation of this plan to the various classes of security holders; upon the deposit of said securities the reorganization committee will cause said depositary to issue to the depositor thereof a deposit receipt therefor; said deposited securities shall be held by said depositary until such time as such securities, in an aggregate amount of each class shall, in the opinion of the undersigned reorganization committee, be sufficient to insure the successful consummation of the plan; upon the written declaration of said committee the plan shall go into effect and the securities deposited with said depositary shall, in exchange for the deposit receipts issued therefor, be delivered to the holders of said deposit receipts with the endorsement upon said securities by reference to a recorded instrument of any change in the terms or conditions of said securities resulting from the acceptance and consummation of this plan.

(Testimony of John H. Smith.)

Petitioner's Exhibit No. 1—(Continued)

12. Withdrawal of Offer to Security Holders: In case the security holders shall not accept this plan by deposit of their securities in such volume as to warrant the undersigned reorganization committee in a determination that this plan may be ultimately successfully consummated, then the said reorganization committee may, in its discretion, declare the termination of this plan, and thereupon any securities deposited hereunder shall, upon tender of the deposit receipts issued therefor, be returned by the depositary to the deposit receipt holders.

13. Nomination of Depositary: The Bank of California, National Association, a corporation organized and existing under the laws of the United States, is hereby designated as the depositary under this plan.

Respectfully submitted,

ISAAC D. HUNT

WATSON EASTMAN

E. S. COLLINS

A. S. KERRY

W. LAIR THOMPSON,

Reorganization Committee.

Third, Whereas, the Board of Directors of said Company has, by resolution duly adopted, approved said plan and authorized its consummation; and,

Fourth, Whereas, this reorganization indenture is executed and recorded for the purpose of definitely fixing the rights of the security holders who may

(Testimony of John H. Smith.)

Petitioner's Exhibit No. 1—(Continued)

accept said plan and deposit their securities under and pursuant thereto, and the rights of holders of deposit receipts for such securities as may be deposited under and pursuant to said plan; and

Now, Therefore, in consideration of the premises and of the mutual agreements herein contained, the parties hereto do hereby severally agree, each party agreeing with each and all the other parties hereto, as follows:

Article I.

Definitions.

The terms defined in this Article I shall, for all purposes in consummation of said plan of reorganization, have the meanings herein specified, unless the context otherwise requires:

Board of Directors: The term "Board of Directors" shall mean the Board of Directors of the Company.

Bonds: The term "bond" or "bonds" shall mean any first mortgage sinking fund 6% gold bond of the Company issued and outstanding under the original mortgage.

[Endorsed]: Filed U.S.B.T.A. Sept. 17, 1942.

By Mr. Phillips:

Q. I hand you Petitioner's Exhibit 1 and ask you if that is a copy of the reorganization indenture which was formulated (handing document to witness)?

(Testimony of John H. Smith.)

A. Yes, it is.

Q. And that indenture includes a copy of the plan of reorganization, I think it is right in front?

A. That is correct, although there is one thing that I am not positive about. That is, from the time this reorganization indenture was formulated, as in this written copy, and the time the plan was really approved by the court, [49] there might have been some slight modification. I don't know, whether that was the case, so your question of whether this is the plan as it was, I don't know but I would say it was except for some possibly,—some modification.

Q. So far as,—

A. (Interposing) But as far as that goes, I recall being back in Washington on the S.E.C. and there might have been some slight changes.

Q. But there weren't any changes you,——

A. (Interposing) I don't recall of any changes, but it seems there was a request for a modification.

Mr. Phillips: I offer that exhibit in evidence.

Mr. Tonjes: Do you recall whether there was any request for any modification with respect to the considerations the Western Cooperage Company was to receive, or was it to receive any under that plan?

The Witness: I don't recall for sure and I might make a peculiar statement, I could go ahead and explain what I have in mind.

The Member: Well, I don't think it would accomplish anything.

(Testimony of John H. Smith.)

Mr. Phillips: It would just be explanatory to bring out whether or not the Western Cooperage Company had the right to receive this stock about,—that was transferred to Mr. Smith. [50]

The Member: Well, we had better go along.

By Mr. Phillips:

Q. During 1934, what progress was made with respect to securing the various security holdings under this proposed reorganization plan?

A. In excess of the required percentage in, I think, 77B requires better than two-thirds of each class of securities to become effective and that was accomplished.

Q. And do you know that whether or not,—did you have something to do with the procuring of the consents of the security holders?

A. I did.

The Member: Now, Mr. Phillips, what are we getting at, for this? The plan for reorganization?

Mr. Phillips: Yes.

The Member: Well, I suppose it all leads up to the point where the taxpayer received something; as a part of the reorganization he receives an option. Let's move up to it now. We have had quite a lot of background, already.

Mr. Phillips: I was getting to this.

By Mr. Phillips:

Q. Now, then, in 1934, what part did you play personally in securing the consent of those security holders?

A. An active part in interviewing many of the holders.

(Testimony of John H. Smith.)

Q. Were you successful in getting a substantial amount [51] of securities under this plan of yours?

A. I was.

Q. Now, in 1934, will you state whether or not you had any conversations with Watson Eastman, relative to your services at that time?

A. I did.

Q. And what transpired with respect to that?

A. We made a verbal option, or I made a promise,—he made a promise to me, by saying that he wanted to reward my services, wanted to reward me for services that I had done in 1934, along the lines you have mentioned, with others in the conduct of the Hawley Pulp & Paper Company. And that, we made an option whereby he would reward me, made an agreement he would reward me for such services.

Q. Was that December, 1934? A. It was.

Q. And that option that was made by Watson Eastman to you was verbal? A. It was.

Q. And in connection with that option was there to be any commitment on your part on any services after 1934?

A. No. This was for services performed prior to that time.

Q. Prior to December 10, 1934?

A. Yes. [52]

Q. In fact, that option that was made had nothing to do with your subsequent connection with the Western Cooperage Company?

A. No, sir.

(Testimony of John H. Smith.)

Q. And your services as an employee of the Western Cooperage Company could be terminated at any time?

A. Yes, sir, that is right.

Q. Irrespective of the option?

A. That is right.

The Member: I don't want to object to leading questions. You don't ask him about a verbal option. That would be a little difficult thing, I think, —I think it would be better for your,——

Mr. Phillips: (Interposing) He was talking to Mr. Eastman.

The Member: Well, of course, the conversations, the promises,—or the thoughts of Mr. Eastman are not material to the issues of this case, or is it still background?

Mr. Phillips: Well, I will put the written documents in and tie them all up with 1934. I was taking them chronologically.

The Member: You mean the verbal option was——

Mr. Phillips: (Interposing) The verbal option here, they were not in existence until 1934 when the terms were reduced to writing and they will be explained. [53]

The Member: Well, you have not asked the witness to give the terms of the verbal agreement.

Mr. Phillips: No.

By Mr. Phillips:

Q. Will you state the terms of the verbal agreement, what the terms of the verbal agreement had with Mr. Eastman were?

(Testimony of John H. Smith.)

A. The terms of the verbal agreement were those as in the written agreement.

Q. Same as in the written agreement?

A. Yes.

Q. When was the written agreement provided for? A. I don't recall exactly.

Q. Well, first, let me ask you then, were the terms of the oral option communicated to the Board of Directors and did they pass a resolution on the same? A. Correct, they did.

Q. And I will hand you what purports to be the minute book of the Western Cooperage Company and ask you if that is the minute book of the Western Cooperage Company? A. It is.

Q. And does that page that I have opened there for you contain the resolution which was adopted by the Board of Directors relative to this oral option? A. It does. [54]

Mr. Phillips: We will offer the minute book in evidence, your Honor, and I would like to substitute a copy, have leave to substitute a copy which I have prepared and you have a copy of the minutes?

Mr. Tonjes: I have.

Mr. Phillips: We will substitute a copy.

The Member: Is there any objection to the copy coming in?

Mr. Tonjes: No objection to the copy.

The Member: It will be received as Petitioner's Exhibit 2.

(Minute book above referred to was marked Petitioner's Exhibit 2 and received in evidence.)

(Testimony of John H. Smith.)

PETITIONER'S EXHIBIT No. 2

Extract from records of Board of Directors at their meeting held May 4, 1937

The President then called the attention of the Board to the matter of arrangements which he had made with John H. Smith, Jr. in regard to distribution of stock of Hawley Pulp and Paper Company to which the Western Cooperage Co. might be entitled under the terms of the Reorganization Indenture of the Hawley Pulp and Paper Company and stated:

"1. As previously mentioned to individual members of the Board that upon the entry of the decree by the District Federal Court at Portland, Oregon, confirming the plan of reorganization of the Hawley Pulp and Paper Company in a 77-B proceeding he had, as President, and on behalf of the Western Cooperage Co. given to John H. Smith, in consideration of his services theretofore rendered in negotiating said plan and in bringing about the deposit of securities enabling the confirmation of said plan, an option

(a) To purchase, at a price of $1.00 per share which was the then fair market value of said stock, 3743 shares of Second Preferred Stock of the Hawley Company deposited by the Western Cooperage Co. under said plan; such option to be void unless exercised within a period of 60 days after the return of said Second Preferred stock to the Cooperage Co; if said option should be exercised by the

(Testimony of John H. Smith.)

said Smith before the return of said stock to the said Cooperage Co., the said Cooperage Co. would file with the Depositary holding said Second Preferred Stock in escrow under the terms of said reorganization plan, a written order directing the said Depositary to deliver, when the Cooperage Co. should be entitled to the return of said stock under the terms of said reorganization plan, to the said Smith said stock as purchased by him in the exercise of said option; and

(b) To purchase on or before January 1, 1940, at a price of $7437.70 the right to receive all common stock of the Hawley Pulp and Paper Company in excess of 100,001 shares to be received by the Cooperage Co. in the performance of its management contract referred to in said plan of reorganization; because of the possibility that the Cooperage Co. may be entitled to receive only a portion of the stock placed in escrow under the said reorganization plan and not be entitled to receive all such stock by reason of management default, then, in case said Smith exercises his said option, the Depositary holding the common stock in escrow under the terms of said reorganization plan be given a written notice by the Cooperage Co. that it had sold its right to receive 74377 shares, accompanied by a written order to deliver the common stock of the Hawley Pulp and Paper Company held by them in escrow at the ratio of six shares to the Cooperage Co. and four shares to John H. Smith until the Cooperage Co. has been thus delivered 100,001 shares and John H. Smith approximately 66667

(Testimony of John H. Smith.)

shares and thenceforth deliver the balance of approximately 7710 shares held in escrow to John H. Smith; all such deliveries to be made by the Depositary when the Cooperage Co. has earned the release of stock by the Depositary as set forth in the said reorganization plan.

2. That the said Second Preferred Stock and Common Stock of the Hawley Company to be returned to and received by the Cooperage Co. under the terms of said reorganization plan has recently increased substantially in market value, and, for that reason, the said option should in fairness to all interested parties and to protect the heirs of said Smith, be recorded by formal instrument to be executed by the Cooperage Co; and

3. That he recommends the adoption of a resolution whereunder his act in giving said option would be ratified, and the executive officers of the corporation would be authorized and directed, for and on behalf of the corporation, to execute and deliver as of December 10, 1934, the date of said decree of confirmation, to said John H. Smith a formal instrument of option embodying the terms of said options aforesaid.

Whereupon, on motion duly made, seconded and unanimously carried, the following resolution was adopted:

Be It Resolved that the act of the President of this corporation on December 10, 1934, in giving to John H. Smith, in consideration of his services theretofore rendered in negotiating the plan of reorganization of Hawley Pulp and Paper Company

(Testimony of John H. Smith.)

and in bringing about the deposit of securities enabling the confirmation of said plan by decree of the District Federal Court of Portland, Oregon, an option

[Printer's Note: In the above paragraph beginning with the words "to John H. Smith," to the end of paragraph, the matter is rung, with the word copy in longhand in the margin.]

(a) To purchase, at a price of $1.00 per share which was the then fair market value thereof, 3743 shares of Second Preferred Stock of the Hawley Pulp and Paper Company deposited by the Cooperage Co. under said plan; such option to be void unless exercised within a period of 60 days after the return of said Second Preferred Stock to the Cooperage Co; if said option should be exercised by the said Smith before the return of said stock to the said Cooperage Co. the said Cooperage Co. would file with the Depositary holding said Second Preferred Stock in escrow under the terms of said reorganization plan, a written order directing the said Depositary to deliver, when the Cooperage Co. should be entitled to the return of said stock under the terms of said reorganization plan, to the said Smith said stock as purchased by him in the exercise of said option; and

(b) To Purchase on or before January 1, 1940, at a price of $7437.70 the right to receive all common stock of the Hawley Pulp and Paper Company in excess of 100,001 shares to be received by the Cooperage Co. in the performance of its manage-

(Testimony of John H. Smith.)

ment contract referred to in said plan of reorganization; because of the possibility that the Cooperage Co. may be entitled to receive only a portion of the stock placed in escrow under the said reorganization plan and not be entitled to receive all such stock by reason of management default, then, in case said Smith exercises his said option, the Depositary holding the common stock in escrow under the terms of said reorganization plan be given a written notice by the Cooperage Co. that it had sold its right to receive 74377 shares, accompanied by a written order to deliver the common stock of the Hawley Pulp and Paper Company held by them in escrow at the ratio of six shares to the Cooperage Co. and four shares to John H. Smith until the Cooperage Co. had been thus delivered 100,001 shares and John H. Smith approximately 66667 shares and thenceforth deliver the balance of approximately 7710 shares held in escrow to John H. Smith; all such deliveries to be made the Depositary when the Cooperage Co. has earned the release of stock by the Depositary as set forth in the said reorganization plan.

Be It Further Resolved, that the executive officers of this corporation be authorized and directed on behalf of this corporation to execute and deliver, as of the 10th day of December, 1934, to John H. Smith, a formal option substantially setting forth the option and the terms and provisions thereof as hereinbeforein this resolution recited.

[Printer's Note: In the above paragraph beginning with the words "that the executive of-

(Testimony of John H. Smith.)

ficers" to the end of the paragraph, the matter is bracketed in margin, with the notation "Copy 2" written in longhand in the margin.]

[Endorsed]: U. S. B. T. A. Filed Sept. 17, 1942.

By Mr. Phillips:

Q. Now, I will hand you, Mr. Smith, what appears to be an option agreement between the Western Cooperage Company and yourself, and ask you if that is the written agreement that was drawn up embodying the terms of the oral option which you previously had? A. It is.

Q. Now, the terms of the oral option, then, that you have referred to are the same that as the terms in this written option? A. That is right.

Mr. Phillips: We will have that marked also. You [55] have a copy of the option agreement?

Mr. Tonjes: I have a copy.

Mr. Phillips. We will offer that in evidence.

The Member: Then without objection that will be received as Petitioner's Exhibit 3.

(Whereupon the written option was marked Petitioner's Exhibit No. 3 and admitted in evidence.)

PETITIONER'S EXHIBIT No. 3

OPTION AGREEMENT

Know All Men By These Presents, that the Western Cooperage Company, a corporation, hereinafter called the "Cooperage Company", in consideration of services rendered by John H. Smith of Portland, Oregon, hereinafter called "said Smith",

(Testimony of John H. Smith.)

prior to the date hereof, in negotiating the plan of reorganization as set forth in the reorganization indenture between the Hawley Pulp and Paper Company, hereinafter called the "Hawley Company", and its depositing security holders of date January 18, 1934, and in bringing about the deposit of securities enabling the confirmation of said plan, does hereby, on this 10th day of December, 1934, grant unto the said John H. Smith, his heirs or assigns, the following several options, either one of which, or both of which, may be exercised by the said Smith, his heirs or assigns, upon compliance by him or them with the terms of the option which is being exercised by him or them; said options are expressed and conditioned as follows, to-wit:

[Printer's Note: Longhand notation in margin "Copy 1."]

Option A

1. To purchase, at the price of $1.00 per share, which is the fair market value thereof as of the date of this option, 3743 shares of the Second Preferred Stock of the Hawley Company deposited by the Cooperage Company under said plan of reorganization.

2. This option shall be void unless exercised by the said Smith, his heirs or assigns, on or before the expiration of a period of sixty (60) days after the return of said Second Preferred Stock to the Cooperage Company under and in accordance with the provisions of said reorganization plan.

3. If said option should be exercised by the said Smith before the return of said stock to the said

(Testimony of John H. Smith.)

Cooperage Company under the provisions of said plan of reorganization, the said Cooperage Company will, upon written request of said Smith, file with the Depositary holding said Second Preferred Stock in escrow under the terms of said reorganization plan a written order directing the said Depositary to deliver, when the Cooperage Company should be entitled to the return of said stock under the terms of said reorganization plan, to the said Smith, the said stock as purchased by him in the exercise of this option.

4. This option may be exercised by the said Smith, his heirs or assigns, at any time hereafter until the expiration of a sixty-day period after the return of said Second Preferred Stock to the Cooperage Company by the delivery to the Cooperage Company of his or their written declaration of the exercise of this option together with the option price ofthree thousand seven hundred forty-three Dollars (3743.00).

[Printer's Note: Written in longhand in the margin the word "Start".]

Option B.

1. To purchase on or before January 1, 1940, at a price of $7437.70, the right to receive all common stock of the Hawley Company in excess of 100,001 shares of the common stock of the Hawley Company to be received by the Cooperage Company in the performance of its management contract referred to in said plan of reorganization.

2. This option shall be void unless exercised by

(Testimony of John H. Smith.)

the said Smith, his heirs or assigns, on or before January 1, 1940.

3. It is possible that the said Smith, his heirs or assigns, may exercise this option and that the said Cooperage Company, by reason of management defaults, may be entitled to receive only a portion of the Common Stock of the Hawley Company placed in escrow under said reorganization plan, and if such be the case then the Cooperage Company will, upon such exercise of this option and upon the written request of said Smith so to do, file with the Depositary holding said Common Stock in escrow under the terms of said reorganization plan a written notice that it has sold to said Smith, his heirs or assigns, its right to receive under said reorganization plan 74,377 shares of the Common Stock of the Hawley Company, and with said writtgn notice the Cooperage Company will file with said Depositary a written order directing the said Depositary to thereafter deliver to the Cooperage Company and said Smith, his heirs or assigns, the said Common Stick of the Hawley Company held by it in escrow and which the Cooperage Company may be entitled to receive, in the proportion of six shares to the Cooperage Company and four shares to the said Smith, his heirs or assigns, until the Cooperage Company shall have received 100,001 shares and the said Smith, his heirs or assigns, shall have received approximately 66,667 shares, and thereafter to deliver the balance of said stock of approximately 7,710 shares to the said Smith, his heirs or assigns.

(Testimony of John H. Smith.)

4. In case this option shall be exercised by said Smith, his heirs or assigns, and if the Cooperage Company may have earned the release to it of said stock in accordance with the provisions set forth in said reorganization plan, then all such deliveries of said Common Stock shall be made by the said Depositary to said Cooperage Company and to said Smith, his heirs or assigns, in the proportion in the next preceding paragraph stated.

5. This option may be exercised at any time hereafter until January 1, 1940, by the delivery by said Smith, his heirs or assigns, to the Cooperage Company of his or their written declaration of the exercise of this option together with the option price of Seven thousand four hundred thirty-seven and 70/100 Dollars ($7437.70).

[Printer's Note: Longhand notation in margin "—to here."]

In Witness Whereof, the Western Cooperage Company, pursuant to a resolution of its Board of Directors, has caused this option to be executed as of the day and year first above written, by its officers as below subscribed.

WESTERN COOPERAGE COMPANY

By Watson Eastman, President

Attest: Louis Woerner, Secretary

Witnesses.

A. L. Homes

Dorothy Andrews

[Endorsed]: U. S. B. T. A. Filed Sept. 17, 1942.

(Testimony of John H. Smith.)

Mr. Phillips: And I would like to substitute a copy.

Mr. Tonjes: No objection to the copy.

The Member: All right. The copy will be marked and received in evidence.

By Mr. Phillips:

Q. This option, "A", was with reference to the second preferred stock of the Hawley Pulp & Paper Company and option "B" with reference to the common stock of the Hawley Pulp & Paper Company. Will you state whether the option "A" has anything to do with this tax matter?

A. No.

Q. That may be withdrawn,—or option "B" of the common stock is the only matter involved in this proceeding? A. That is right.

Q. Now, under the terms of this option "B" which was to be exercised prior to January 1, 1940, will you state whether or not you exercised your right to purchase under this option agreement?

[56]

A. I did.

Q. And on what date did you exercise that option to purchase?

A. I forget the exact date. It would be just prior to March 19, 1938, I would judge from the record as I have here.

Q. When you did exercise your option, did you purchase the stock referred to in the option?

A. I did.

Q. Both common and preferred?

(Testimony of John H. Smith.)

A. I did.

Mr. Tonjes: Was the option in writing, that option referred to, was that in writing?

The Witness: I don't recall.

By Mr. Phillips:

Q. I hand you your own check drawn to the Western Cooperage Company dated March 21, 1938, and ask you if that was in payment both of the common and second preferred stock under the terms of the option? A. It was.

Mr. Phillips: We offer that in evidence, check for $11,180 covering both of those. We will offer this check in evidence.

Mr. Tonjes: All right.

The Member: The check will be received in evidence as Petitioner's Exhibit 4. [57]

(Check above referred to marked Petitioner's Exhibit No. 4 and received in evidence.)

PETITIONER'S EXHIBIT No. 4

Portland, Ore., March 21st, 1938 No. 3538
The United States National Bank 24-11
Of Portland, Oregon

Pay to the Order of Western Cooperage Co. $11180.70
Eleven Thousand one hundred eighty & 70/100 .....Dollars
JOHN H. SMITH, JR.
1-2

Pay to the Order of
The United States National Bank
266 Portland, Oregon 266
Western Cooperage Co.
[Pencil marks illegible.]

[Endorsed]: U. S. B. T. A. Filed Sept. 17, 1942.

(Testimony of John H. Smith.)

The Member: What is that check?

Mr. Phillips: That is the check which Mr. Smith gave to the Western Cooperage Company in payment of the stock.

The Member: How much is it?

Mr. Phillips: It is for $11,180.70 and the check is No. 3538 and is dated March 21, 1938.

The Member: What was that for again?

Mr. Phillips: $11,180.70.

By Mr. Phillips:

Q. Now, Mr. Smith, under the terms of your option you were purchasing 74,377 shares of common stock. How much of that check was in payment of the common stock?

A. $7,437.70, I would assume, from this check, or that figure.

Q. On the common stock? A. Yes.

Q. And the balance was $3,743, was in payment of the preferred? A. That is right.

Q. Now, will you state to the Board when you actually received the stock pursuant to this delivery?

The Member: You don't mean pursuant to the delivery.

Mr. Phillips: Pursuant to the exercise of his option. [58]

A. March 19, 1938.

The Member: What stock was received?

The Witness: On that date there was a second preferred amount, which you have a record of there, and unfortunately I haven't,—the amount of shares

(Testimony of John H. Smith.)

was 3,743 shares as I recall, but I would not be sure of that figure. That was the second preferred stock.

The Member: Is that material, how much of it there was?

Mr. Phillips: No, that would not be material.

By Mr. Phillips:

Q. And how much common?

A. Well, on that sheet,—33,759 shares of the common stock.

Q. You might just tell us how much of the common you received and on what dates, that is, all in issue.

A. On February 3, 1939, I received 3,661 shares. On November 1, 1939, I received 2,680 shares. On December 28, 1939, I received 6,033 shares and on April 12, 1940, 5,210 shares. November 13, 1940, 12,146 shares. On January 8, 1941, 10,858 and one-twenty-fourth shares or a total of 74,377-1/24 shares.

Q. Now, Mr. Smith, referring back to your oral agreement of 1934, will you please state whether or not you knew or did know anything about the market values of the common stock of [59] Hawley Pulp & Paper Company in that period of time?

A. Well, I don't think they had any market value although there was some slight transactions that I have heard of that figures under 10c a share.

Q. When you and Watson Eastman had your talks relative to this oral option and made your agreement, your oral agreement for this purchase

(Testimony of John H. Smith.)

of these shares, or, at least the right to purchase the shares, was there any discussion had as to the price? A. There was.

Q. And will you tell the Board how you arrived at the price?

A. I tried to investigate to see what the market price was and as I say, I don't think there was any market price, although we found transactions and we set the option value at what we thought was in excess slightly of the market price as compared by these transactions, as indicated of these transactions.

Q. And did you have a purpose in setting the market price in excess of the market value at that time?

A. I had a purpose in doing it but I preferred to have this on the purchase basis.

Q. You had preferred to have it be a purchase rather than a gift? A. That is right. [60]

Q. And what was the general financial condition of Hawley Pulp & Paper in December of 1934?

A. Well, in 1932 they lost something in excess of a half a million dollars and in 1933, although we were in management during that year their loss was very excessive, although not to that point and because of these losses the bonds on a flat basis were selling at,—I know of one rather sizable transaction made by the United States National Bank as a flat rate of $17.50 on a hundred.

Q. First mortgage bonds? A. Yes.

(Testimony of John H. Smith.)

Q. Secured on what properties?

A. On all the properties.

Q. Including the principal mill at Oregon City?

A. Yes.

Q. Well, then underneath the bonds, what was the next indebtedness at that time?

A. A note of $500,000 with accrued interest.

Q. And do you know anything about the market values of the first preferred stock at that time?

A. The first preferred stock at that time had a market value, at that time, of approximately $2.50.

Q. And what was the approximate market value at that time of the second preferred stock?

A. I could not find any transaction, as I recall. [61]

Q. None at all? A. No.

Q. And all the transactions as you recall it on common were less than 10c a share?

A. Yes, sir.

Q. Now, after 1934, did you receive a salary as an employee of the Western Cooperage Company?

A. I did.

Q. And did you receive anything in addition to money as compensation for services in connection with your employment there? A. I did not.

Q. You did not?

A. You are referring to the Western Cooperage Company?

Q. Yes, Western Cooperage Company. You were also an employee of the Hawley Pulp & Paper Company, I think?

(Testimony of John H. Smith.)

A. Well, I also received a salary there, is what I was thinking of.

Q. Yes, you received a salary. Now, in 1938 when you received these shares from the Western Cooperage Company, what officer of the Western Cooperage Company, what office were you holding at that time? A. I was vice-president.

Q. And did the,—you were vice-president?

A. Yes. [62]

Q. Do you know whether or not the Western Cooperage Company reported upon its books any part of this stock that you received? As additional compensation to you in any way?

A. No, I know they did not.

Q. They did not report *is* as any additional compensation to you? A. No.

Q. Now, have you had occasion to sell any of this stock since you have received it, this common stock? A. I have.

Q. And when did you make sales?

A. I made sales both in the year 1940 and in the year 1941.

Q. In order to refresh your memory, if you care to do so, I will hand you your 1940 and 1941 income tax returns and ask you if you can examine those and tell as to how many shares of the common stock you sold in 1940?

Mr. Tonjes: That is objected to as being immaterial.

Mr. Phillips: If your Honor please, the purpose of this of course is to show that Mr. Smith

(Testimony of John H. Smith.)

did sell his stock in 1940 and 1941, that is, he sold a part of it, he did not sell all of it and that he took as his basis the same 10c a share which is our theory of the case and I think it is borne out. The purchase in a transaction of this kind involves the time of the sale and not the agreement and I would like to have [63] the record show the date.

Mr. Tonjes: The Respondent submits, your Honor, that the manner in which the Petitioner computed any date is in no way binding upon the Respondent; whether he is correct in using that date, is of course the question we have before the board.

The Member: Overrule the objection. You may answer the question.

Mr. Phillips: You may answer the question and tell how many shares you sold.

A. It shows sold 22,939. It is a little faint there, it might be 900 even. I will have to add it up. No, I think it was 22,939.

Q. And at what base, on what basis did you sell that stock, that is, what did you take for your cost basis? A. 10c a share.

Q. And you computed your gain on 10c a share as cost basis? A. Yes.

Q. And reported it as income and reported your tax return? A. Yes.

Q. Now, in 1941, will you state how many shares of this common stock you sold?

A. 9,000 shares.

(Testimony of John H. Smith.)

Q. And on what cost basis did you report that? [64] A. 10c a share.

Q. And on that cost basis was your income computed in return? A. It was.

Q. In profit, the difference between your cost and selling price? A. It was.

Q. And you paid a tax on that profit in 1941, for the year 1941? A. I did.

Q. Perhaps I asked you before, with respect to this option; did your future employment after 1934 depend in any way upon this option agreement?

A. It did not.

Q. Your option agreement was just the same as it was, as if it were with a stranger?

A. Yes, that is right.

Q. Now, for the purpose of the record also, will you state who the depository was under the terms of the reorganization indenture?

A. The Bank of California at Portland.

Q. I would like to offer in evidence a letter from the Western Cooperage Company addressed to the Bank of California, N. A., depository, March 18, 1938. You have seen this? A. Yes.

Mr. Phillips: And Mr. Tonjes, he has examined it, [65] the orginal, brought by a young man from the Tax Department who was here prior to the time your Honor stepped down, and I would like to offer that, which was an offer, and an order delivered to Mr. Smith, under the terms of the reorganization indenture.

Mr. Tonjes: No objection.

(Testimony of John H. Smith.)

Mr. Phillips: I would like to submit a copy and the original may be returned.

The Member: All right. The copy may be filed and the Petitioner's Exhibit 5 will be received in evidence.

(Whereupon the letter above referred was marked Petitioner's Exhibit 5 and received in evidence.)

PETITIONER'S EXHIBIT No. 5

March 18, 1938.

The Bank of California, National Association,
Depositary,
Portland, Oregon.

Attention Mr. Day:

Gentlemen:

In re: Distribution of Second Preferred Stock and Voting Trust Certificates of Common Stock under paragraph (L) of the Reorganization Indenture of the Hawley Pulp and Paper Company.

Paragraph (L) of the Reorganization Indenture of the Hawley Pulp and Paper Company of January 18, 1934, provides as follows:

"(L) Not less than 85% of the voting trust certificates of Common stock, and not less than 85% of the Second Preferred stock shall be deposited in escrow with the Depositary to be selected by the Board of Directors; if, as and when $1,400,000.00 par value of said outstand-

(Testimony of John H. Smith.)

ing indebtedness, consisting of said bonds and said notes, shall have been purchased and retired under the present management, as contemplated by subparagraphs (E), (F) and (G) hereof, then the said Depositary shall deliver to the present management such a number of shares of said Second Preferred stock and/or voting trust certificates of Common stock as shall bear the same ratio to the total number of shares of Second Preferred stock and voting trust certificates of Common stock so deposited in escrow as said amount of $1,400,000.00 of said retired indebtedness shall bear to $2,790,-150.00; thereafter, the said Depositary shall annually deliver to the management such a number of shares of said Second Preferred stock and/or voting trust certificates of Common stock as shall bear the same ratio to the total number of shares of Second Preferred stock and voting trust certificates of Common stock so deposited in escrow as the amount of any annual retirement of par value of bonds and principal of note under the provisions of sub-paragraphs (E), (F) and (G) hereof shall bear to $2,790,-150.00; provided, however, that the Second Preferred stock shall be first delivered."

As you know, the Western Cooperage Company is the "present management" referred to in the aforequoted excerpt from said reorganization indenture.

(Testimony of John H. Smith.)

As you know, the Western Cooperage Company is the "present management" referred to in the aforequoted excerpt from said reorganization indenture.

The indebtedness of $2,790,150.00 mentioned in the above quoted excerpt from said reorganization indenture is made up of the following items, as shown in paragraph "1" of the plan of reorganization as recited in said reorganization indenture:

6% First Mortgage Bonds due 7/1/46	$2,127,500.00	
Interest accrued to 1/1/34	127,650.00	$2,255,150.00
Hereinafter called "Bonds"		
7% Note due 7/1/34	500,000.00	
Interest accrued to 1/1/34	35,000.00	535,000.00
Hereinafter called "Note"		
Total		$2,790,150.00

Of said indebtedness of $2,790,150.00, the present management has retired the following:

6% First Mortgage Bonds due 7/1/46	$1,212,000.00	
Interest accrued to 1/1/34 on said bonds retired	72,720.00	
Principal of 7% Note due 7/1/34	125,000.00	
Total retirement,		$1,409,720.00

The retirement of First Mortgage Bonds and interest thereon are evidenced by your files, which will disclose that said bonds have been cancelled by you.

The evidence of the retirement of the principal of said note is evidenced by the endorsement upon said note, a photostatic copy of which note and endorsement is attached hereto.

(Testimony of John H. Smith.)

You hold in escrow under the aforequoted paragraph "(L)" of the reorganization indenture 7,487 2/3 shares of the Second Preferred stock of the Hawley Pulp and Paper Company and voting trust certificates representing 174,378 1/24 shares of Common Stock, or a total number of shares held or represented by voting trust certificates in the amount of 181,865 17/24.

Under the terms of the aforequoted paragraph "(L)" of the reorganization indenture, the Western Cooperage Company is now entitled by reason of the retirement of said indebtedness in the amount of $1,409,720.00 to receive from you such a number of shares of Second Preferred Stock and of Common stock represented by voting trust certificates as shall bear the same ratio to the total number of shares of Second Preferred stock held by you and of Common stock represented by voting trust certificates held by you, to-wit, 181,865 17/24 shares as said retired indebtedness in the amount of $1,409,720.00 may bear to said total indebtedness of $2,790,150.00, or 91,887 shares, provided that the Second Preferred stock shall be first delivered. Accordingly, the Western Cooperage Company is now entitled to receive from you all of said Second Preferred stock in the amount of 7,487 2/3 shares and Voting Trust Certificates representing 84,399 1/3 shares of Common stock of the Hawley Pulp and Paper Company.

By virtue of the exercise of an option under a

(Testimony of John H. Smith.)

contract heretofore entered into between the Western Cooperage Company and John H. Smith, the said John H. Smith is entitled to receive, out of said 7,487 2/3 shares of Second Preferred stock, 3743 shares of said Second Preferred Stock of the Hawley Pulp & Paper Company. Likewise, by virtue of the exercise of an option under a contract heretofore entered into between the Western Cooperage Company and John H. Smith, the said John H. Smith is entitled to receive, out of the voting trust certificates as aforesaid, representing 84,399 1/3 shares of the Common Stock of the Hawley Pulp and Paper Company, a voting trust certificate representing 33,759 shares of the Common Stock of the Hawley Pulp and Paper Company.

Accordingly, the Western Cooperage Company demands that you issue and deliver the Second Preferred stock of the Hawley Pulp and Paper Company and voting trust certificates representing the Common stock of the Hawley Pulp and Paper Company which it may be entitled to receive as aforesaid, as follows:

3744 2/3 shares of said Second Preferred stock to the Western Cooperage Company,

3743 shares of said Second Preferred stock to John H. Smith

Voting trust certificates representing 50,939½ shares of said Common stock of the Hawley Pulp and Paper Company to Western Cooperage Company

(Testimony of John H. Smith.)

Voting trust certificates representing 33,759 shares of said Common stock to John H. Smith.

Yours truly,

WESTERN COOPERAGE COMPANY

By WATSON EASTMAN
President

LOUIS WOERNER
Secretary

[Endorsed]: U. S. B. T. A. Filed Sept. 17, 1942.

Mr. Phillips:

Q. Now, Mr. Smith, with respect to a,—oh, there was, what was I thinking. I have here a copy of the "Oregon Voter", a list of the stock publications. All of the Hawley securities, and I was going to offer that in evidence.

Mr. Phillips: We will offer at this time, if your Honor please, the copy of the "Oregon Voter" for June 12, 1937, showing local securities. This is a publication of Portland, Oregon, and shows the range of four years on the Hawley Pulp & Paper Common stock. Also shows their preferred and common and second preferred for three years.

Mr. Tonjes: We have no objection.

The Member: It will be received as Petitioner's Exhibit 6. [66]

(Copy of "Oregon Voter" marked as Petitioner's Exhibit 6 and received in evidence.)

(Testimony of John H. Smith.)

PETITIONER'S EXHIBIT NO. 6

PORTION OF EXHIBIT #6

June 12, 1937 Oregon Voter (305) 13

LOCAL SECURITIES PRICE RANGE—4 YEARS

Bid Quotations Provided by Bond Traders' Club of Portland

Stocks	6/1/37	6/1/36	6/2/35	6/3/34
California Oregon Power 6% pfd	86	77	....	....
California Oregon Power 7% pfd	96	81	....	....
Columbia Riv Paper Mills 8% pfd	42½	33	24	10
Hawley Pulp & Paper com	6	½	¼	V
Hawley Pulp & Paper 1st 7% pfd	44	11	5	4V
Jantzen Knitting Mills com	18	11¾	8	....
Jantzen Knitting Mills pfd	95	102	97½	80xd
Mountain States Power 7% pfd	33	34	14½	7
Northwestern Electric Co. 7% pfd	74	69½	41	13
Northwestern Port Cement units	Ofd 79	53	42	42
Oregon Portland Cement com	5	2½	2½	4
Oregon Portland Cement 7% conv pfd	56	53	25	30
Oregon Portland Cement 7% cum pfd	95	90	60	50
Oregon Pulp & Paper 8% pfd	76½	44	28	15
Portland Elec Power 7% prior pfd	6	4½	2½	Ofd 3
Pacific Pow & Light Co. 7% pfd	68½	82	51½	14
Portland Gas & Coke Co. 7% pfd.	36½	29½	26	20

(Testimony of John H. Smith.)

Local Securities Price Range—4 Years—(Continued)

St Helens Pulp & Paper com	24¼	16	10	8½
U S National Bank Port ($20 pv)	39	36½	29	30
West Coast Telephone 6% pfd ($25 pv)	20	18	5½	2½
Bonds				
Arlington Club 6s	95	95	60	50
Beaver Portland Cement 7s	88	70	50	41
Columbia Riv Packers 2s '50	26f	....	....	....
Columbia River Paper Mills 6s	90	90	75	64
Hawley Pulp & Paper 6s	95f	62½f	42	33
Home Service 7s	48f	25f	45	35
Keller Boyd Building 6s	88	77	65	60
Medical Arts Building 5½s	93f	80	59	37
Morgan Bldg 6s	Ofd 12f	14f	Ofd 17	15
Mountain States Power 6s '38	93½	97	82	61
Multnomah A A Club 6s	35f	30f	25	32
Northwestern Bldg LTC 5½s	88	84	72	....
Oregon Pulp & Paper 6s	93	95	82	67
Oregon-Wash Telephone 6s '45	97	94½	85	70
Oregon Terminal 5s '45	49	51	16½	....
Pacific Properties 6s '46	47f	43f	36f	32
Pittock Block 6s	53f	40	30	35
Portland Elec Pow inc 6s '50	18f	17	15	11
Portland Pantages Building 6s	72f	43	32	Ofd 35
Portland Masonic Temple 5s	Ofd 85	90	80	....
Portland Woolen Mills 6½s	97	94	60	38
Willamette Valley Southern 6s	14f	15½	15	27½
West Coast Telephone 5s '53	95	94½	80	63

f = "flat," accrued interest disregarded; Ofd = price at which offered; xd = ex-dividend. Absence of quotations means that no satisfactory record of quotations was available.

(Testimony of John H. Smith.)

By Mr. Phillips:

Q. Now, before we leave you. Oh, yes. With respect to the San Juan Mining Syndicate, will you tell the Court when that was purchased.

The Member: Just a moment. Are you going to the next issue?

Mr. Phillips: Yes.

The Member: I would like to have the issues tried separately.

Mr. Phillips: That will be perfectly all right. I will call Mr. Smith on the latter issue.

The Member: He can be cross-examined then and I want to ask him a few questions.

Mr. Phillips: Yes, you may step down, Mr. Smith. Or, just a moment.

Mr. Tonjes: I will ask a couple of questions.

Cross Examination

By Mr. Tonjes:

Q. Mr. Smith, what was the occasion for the reduction of the agreement in 1934 to writing in 1937?

A. The Western Cooperage Corporate affairs, due to its being such a closed corporation, were carried on rather loosely. The corporation counsel was Thomas E. Warren,—I mean, Warren [67] E. Thomas. And when Mr. Thomas passed away, naturally other counsel was secured and, when the other counsel was acquainting himself with our affairs, this was one of the things he ascertained, that there was oral option and he immediately ad-

(Testimony of John H. Smith.)

vised us that that should be reduced to writing, so at the next directors' meeting the resolution was passed and a copy of which has been offered in evidence, a written copy was executed shortly thereafter.

Q. Now, in 1934, when you first got the option to buy stock of the Hawley Pulp & Paper Company, do you know whether or not the Western Cooperage Company was the owner of any shares of the common stock of the Hawley Pulp & Paper?

A. In 1934?

Q. Yes.

A. In 1934 they were not owners of common stock.

Q. Then there would have been no option you could have exercised at that time, was there?

A. The option to receive the stock,—only the stock they would be entitled to as provided for in the reorganization indenture.

Q. And in 1934 there had been no stock delivered to the Western Cooperage Company pursuant to the indenture, had there?

A. The stock in question was deposited with the Bank of California, and I don't recall the exact date, but it was prior, considerably prior to the formal code order on the indenture and [68] I rather think it was deposited sooner than January 1, 1934, but I would have to check that to be positive. I don't remember that date.

Q. Well, you mean that you, had you exercised

(Testimony of John H. Smith.)

an option immediately upon its receipt by you in 1934, you could have demanded delivery?

A. No, I could not have demanded delivery, no. Nor, would they be in a position to deliver. It was only on the fulfillment of certain,—of certain stages in the reorganization agreement that they could have delivered or I could demand.

Q. Yes. And when were the requirements met so that the Western Cooperage Company would be entitled to shares of stock of the Hawley Pulp & Paper?

A. Approximately the same dates I gave as when I acquired the stock. They did not get it all at one time. There were a number of deliveries and the dates were within a day or two of the dates listed.

Q. Was the delivery of stock as set forth in the letter of the escrow holder, the order for the first delivery?

A. That was the first delivery. I would see the order, if I may, in order to answer to be correct. (Perusing document.) Yes, that was the order for the first delivery.

Q. Then that, prior to that date, you could not have effectively exercised your option, could you? A. Oh, yes. [69]

Q. Well, how could you?

A. As I understand your question, I will put it that way, that I could have exercised my option any time between the date of the option and January, 1940. I could not have received the stock.

(Testimony of John H. Smith.)

Q. That was what I had in mind. You would not have received the stock in pursuance to the terms of the option. I will state it that way.

A. That is right.

Q. And did you report any income in 1934 on account of the receipt of this option?

A. I did not.

Q. Now, Mr. Smith, you used the expression that you would rather acquire the stock of the Hawley Pulp & Paper by purchase?

A. Yes, sir.

Q. Than any other method. A. Yes, sir.

Q. Now, the option, however, to buy the stock was given to you for services rendered, is that correct,—is it not?

A. That is correct.

Mr. Tonjes: I think that is all.

Redirect Examination

By Mr. Phillips:

Q. Again we will submit, with respect to your 1934 income [70] tax return and this option, did you consider your option of any value in 1934?

A. No, I did not, because we had probably set a price that we felt was in excess of the market.

Q. That is, the option, in and of itself was not a commodity that you could recover anything on at that time?

A. Oh, I might have been able to go out and sell it for a negligible amount, but I don't know where I would look for a sale, even.

(Testimony of John H. Smith.)

Q. It would be a very nominal amount?

A. Yes.

Q. If you did find a buyer?

A. Yes, because the option called for an option to buy the stock that was in excess of the market value of the particular stock.

Q. And the very transactions were in the stock itself? A. That is right.

Q. When you referred to services rendered as a consideration for this option, you mean services rendered during 1934 or at least prior to December 10, 1934?

A. Yes, sir. I would like to have the opportunity to elaborate there a little, if I may.

Q. I think you may.

A. You asked me on first examination whether this was for services rendered and I said yes, and you asked if these [71] services were for getting the consent of the various security holders, and I said yes. That was only part of the services. In addition, I personally was responsible to get for the Western Cooperage Company,—I forget the exact figure, but I would say,—it was virtually approximately 6,000 shares of second preferred and also to get together an additional slightly in excess of 4,000 shares in common, in addition to what the original compensation was to be to the Western Cooperage Company, what that was to be for management and it was because of that particular change that I had in mind when you asked the

(Testimony of John H. Smith.)

there was any change in that indenture and the final indenture that was accepted and I don't recall about that, I think there possibly was some little change in it but I forget the dates.

Q. What—change in the amount of securities?

A. Yes, sir.

Q. Now, did you have anything to do with the acquisition of the note?

A. Yes. I acquired the note for the Western Cooperage Company at a material discount.

Q. That is the half a million dollars referred to in the reorganization indenture?

A. That is correct.

Q. $500,000? A. That's right. [72]

Q. And you got that at a substantial discount for the Western Cooperage Company?

A. Yes, sir.

Mr. Phillips: I think that is all.

Mr. Tonjes: No further questions.

The Member: What is the Respondent's story?

The Witness: I am sorry I could not hear the question.

The Member: No, I am not speaking to you, I am speaking to Counsel for the Respondent. What is the Respondent's theory of the case?

Mr. Tonjes: The Respondent's theory is that the taxpayer received as compensation an option to buy stock, at specified price, and that he exercised that option in the taxable year and acquired part of the stock worth $2.50 for 10c and that there-

fore he realized taxable income to the extent of the difference between the option price and the fair value.

The Member: Is it agreed that the stock had a market price in 1938 and 1939 of $2.00 a share?

Mr. Phillips: I would not be too much against it if they wanted to say it was $2.00 in 1938, I don't have too much in mind on that.

The Member: So then, the amount added to taxable income between the $2.00 and the 10c is an amount I am trying to find out, is that agreeable?

[73]

Mr. Phillips: What you are interested in is the market value in 1938, isn't it?

The Member: No, it is important to know what you consider the market value to be, Mr. Phillips; you agree with Counsel's figures?

Mr. Phillips: I would not agree with their mathematics on the Commissioner's letter but I would be quite willing to stipulate with Counsel if he wants to use that value of $2.50 in 1938.

Mr. Tonjes: When I said $2.50 I meant to use the amount used by the Respondent and his deficiency.

Mr. Phillips: We also have another notice in 1939—we had a certain number of shares came in in 1939, and they did not receive those. After Mr. Smith resigned they received certain shares in 1940 and 1941 and they lumped them in its earnings.

The Member: You have checked your proof of the evidence?

Mr. Phillips: I have checked with Mr. Tonjes on the issues.

The Member: Oh, you have checked with Mr. Tonjes on the issues. Well, I want to save my questions of Mr. Smith until later. I want to check and summarize some of the figures and I can't get that now. I think I will do this now. In 1938 the Commissioner determined the income was under —[74] stated by the amount of $81,021.60. Now, that figure was the result of the following: The Commissioner said that the voting trust certificates, —I suppose that the order he received in 1938 was common stock. But the common stock received in 1938 was valued by the Commissioner at $84,397.50. Is that correct?

Mr. Tonjes: That is correct.

The Member: How many shares entered into that transfer?

Mr. Phillips: 33,759.

The Member: That number of shares were purchased in 1938, is that right?

Mr. Phillips: That number of shares were received in 1938, as being delivered to Mr. Smith.

The Member: Didn't Mr. Smith get any consideration? I thought he had an option to purchase them?

Mr. Phillips: He had an option, an entire option to purchase 74,377 shares and this 33,000 was a part of this 74,377.

The Member: I understand.

Mr. Phillips: When he exercised his option to purchase in March, 1938, by this check of $11,000

—odd dollars, one part of which was in payment of 74,377 shares. In other words, he paid for all of the shares he was entitled to receive under the option in one payment. [75]

The Member: In March, 1938?

Mr. Phillips: In March, 1938, as he has testified here when the check was offered in evidence.

The Member: All right. Then the price used by the Commissioner in computing the gain of $3375.90 is 10c a share. That is clear now.

Mr. Phillips: That is the 10c per share.

The Member: And in 1939 the balance of the stock came in to the Petitioner, is that right, the balance between 33,000-odd shares and 74,377 shares and the additional 1/24 of a share. I guess that 1/24 of a share is immaterial; no, no, that is wrong.

Mr. Phillips: No, no, that is wrong. 12,404.

Mr. Tonjes: 12,405.

Mr. Phillips: No, 12,404.

Mr. Tonjes: All right.

Mr. Phillips: 12,404.

Mr. Tonjes: Now, is it agreed he received that money in 1939?

Mr. Phillips: Yes, that is our figures, too.

The Member: Then the Commissioner determined the fair value at the time of the receipt of that stock in 1939 was $72,901.38.

Mr. Tonjes: That is correct.

The Member: And again, you don't dispute that, that [76] is, you accept that as being a fair statement of the market price, is that correct?

Mr. Phillips: I see. They are using a gradu-

ated scale during the year on the three dates of acquisition. What do you have?

Mr. Tonjes: The figures, I believe, your Honor, are for the block of 366.

The Member: No, you have that wrong; it is 3,661.

Mr. Tonjes: That is what it is, 3,661 on February 23, 1939,—$4 a share, and the next block of November 1, 1939, 2,680 shares at $6.75 and another block on December 20, 1939 of 6,063 shares and at $6.62½, making a total of $72,901.38.

Mr. Phillips: We are agreeable that the market values per share as stated by Mr. Tonjes was the market value at those particular dates.

The Member: What was the market value used for the stocks in 1938?

Mr. Tonjes: $2.50 a share in 1938.

The Member: Just one block?

Mr. Tonjes: That was for just one block.

Mr. Phillips: One block.

The Member: I think that that is all right, then.

Mr. Phillips: Did you wish to proceed to the next witness, your Honor?

The Member: Yes, I think we will just finish every- [77] thing on that issue and, just recall Mr. Smith.

Mr. Phillips: All right.

The Clerk: Will you state your name to the reporter, please.

The Witness: Cassius R. Peck.

CASSIUS R. PECK

was called as a witness for and on behalf of the Petitioner and having been first duly sworn was examined and testified as follows:

Direct Examination

By Mr. Phillips:

Q. Mr. Beck, where do you reside?

A. Portland, Oregon.

Q. What is your business or profession?

A. Attorney.

Q. And how long have you been an attorney?

A. Since 1903.

Q. In Oregon, all the time?

A. In Oregon since 1909.

Q. Now, did you have occasion to discuss with Major Eastman, or Watson Eastman, as he has been referred to, and John H. Smith with reference to the oral option that Mr. Smith has referred to in his testimony here? A. I did.

Q. You heard Mr. Smith's testimony, did you? [78]

A. I have.

Q. Will you state to the Board in that matter, first, how did it come to your attention and what transpired?

A. It was sometime in the spring of 1937, the circumstances were these: That Mr. Thomas had been counsel, general counsel and in charge of the legal affairs and corporate affairs of the Western Cooperage Company for many years. He became very ill in the spring of 1937 and while he was

(Testimony of Cassius R. Peck.)

ill, I think that he had not yet died, although his death was imminent and definite. I was called to the office of the Western Cooperage Company for a general conference with reference to the general affairs of the Western Cooperage Company and at that time the matter of this verbal option was told to me and I at that time told them that that was a matter that could not be handled in that way from a corporate standpoint. I said it would have to be authorized by a resolution of the board of directors and that must be reduced to writing and must be put in contract form in order to protect the corporation and in order to protect Mr. Smith and his heirs in case of his death.

Q. And what transpired after your suggestions to them?

A. A special meeting of the board of directors was called in, you have the record there. It runs in my mind it was early in May, 1937; and a resolution was prepared by me for the,—for submission to the Board. This was at the [79] meeting of May 4, 1937. On the basis of this, and I would say, that the first time that the matter came to my attention would probably be sometime in March. I notice that the notices calling the board meeting was sometime in April.

Q. Did you draw the resolution, the form of the resolution, the body of this agreement?

A. Yes. I drew the form of the resolution based upon what I had been told, and what was told me by Major Eastman and Mr. Smith as being the

(Testimony of Cassius R. Peck.)

basis of the oral option and having heard the testimony here, I wish to call attention to one fact: That the option "A" is a purchase of certain shares, Mr. Tonjes. Option "A". And that, the reason of the differential between the second preferred stock as contained in option "A" and the common stock as contained in option "B" is that the second preferred stock as contained in option "A" belonged to the Western Cooperage Company, and had been deposited to the Western Cooperage Company as a bond of performance under the reorganization indenture and after the reorganization indenture fell down and they did not complete the reorganization indenture, they fell down and they had an opportunity to resell; on the other hand the common stock did not belong to the Western Cooperage Company until they received it by performance of the reorganization so that option "B", you will note, provides for the purchase of the right to receive and not to purchase the actual shares. [80] Option "B", you will notice, referring to the exhibit,——

Q. That is exhibit,——

The Member (Interposing): No. 3.

By Mr. Phillips:

Q. Exhibit 3?

A. (Continuing): ——Exhibit 3, provides for the purchasing on or before January 1, 1940, the right to receive all of the common stock of the Hawley Pulp & Paper Company, in excess, and so forth; and the option also provides for contingency in

(Testimony of Cassius R. Peck.)

case the management should fall down and should not be able to receive any of the stock. So this option provided for a right to receive, as to option "A", because as to option "A", the——

Mr. Tonjes (Interposing): Your Honor, I object to this line of testimony by the witness as it is purely argumentative. The record is in the minutes and I presume they set forth what the board of directors intended.

The Member: I suppose it would be proper to have an explanation of the documents in the record. The witness is an attorney who was called in at the time the verbal option given to the taxpayer was being discussed. His answer goes beyond the question, but that is all right. Now, will you go ahead and ask the next question.

By Mr. Phillips:

Q. Now, as to Major Watson Eastman, he is not living [81] at the present time?

A. No, sir.

Q. You know approximately when he died?

A. Well, time flies pretty fast, but I would say about two years ago.

Q. About June of 1940? A. Yes.

Q. That would be right? A. Yes.

Q. Do you know anything about the market value of the stock of the Hawley Pulp & Paper Company in 1934? Did you have any contact with that?

A. Yes. I had charge of the reorganization of the Hawley Pulp & Paper Company and I was the

(Testimony of Cassius R. Peck.)

attorney for the Hawley Pulp & Paper and,—for that organization,—and I drew up the reorganization indenture, which is in evidence, and I am very much interested in the deposits of all the securities at the time, or the securities that were deposited under the reorganization indenture and, because of my familiarity with those deposits and also due to the fact that I owned some of the common stock and some of the first preferred stock myself, I did know something about the value. I would not pretend I am qualified as an expert in values.

Q. From what you know, would you say a valuation of [32] 10c would equal, or, at least, would be equal or more than equal to the market value as of December 10, 1934?

Mr. Tonjes: I object to that on the grounds that the witness is not qualified to answer that question.

Mr. Phillips: I realize that the witness' qualifications and the weight to be given is a matter for the Court to determine from Mr. Peck's experience. He has given the substance of his experience.

The Member: I will overrule the objection, but I want you to ask the witness to explain his answer.

Mr. Phillips: All right.

By Mr. Phillips:

Q. Will you kindly explain what in your opin-

(Testimony of Cassius R. Peck.)

ion the value of the stock was in 1934, and then explain your answer?

A. On December 10, 1934, I would say that the common stock of the Hawley Pulp & Paper had a market value which was something less than 10c per share. And in explanation of that answer, I would add: December 10, 1934, was the date as I recall on which the Court confirmed the plan of reorganization, and at that time I know that the bonds of the corporation, first mortgage bonds, which of course were ahead of all of the securities, of the corporation, had a market value of not to exceed $30 a share, $30 per one hundred, of par value, of face value. And I know that the first preferred stock, I know that the note of $500,000 had [83] been deposited by Mr. Smith upon a discount basis of $375,000, and under an arrangement whereby the depositor was to be paid on that note not the full amount of $500,000, but the $375,000 only, if, as and when that $375,000 might be recovered in the reorganization proceedings by making the note good. I know that the first preferred stock had a value at that time of not to exceed five or six dollars per share. And I know that the,—that there was transfers of the common stock at that time at most nominal values. I know of one transfer, and it is the only, that I actually know of, at 5c a share.

Mr. Phillips: You may examine.

Cross Examination

By Mr. Tonjes:

Q. Mr. Peck, you say that the bonds of the cor-

(Testimony of Cassius R. Peck.)

poration were selling at about $30 per hundred?

A. Yes, that is my recollection.

Q. And there was also a considerable block of preferred stock outstanding which had a priority over the common stock?

A. Oh, yes, 20,000 shares.

Q. How do you arrive at the conclusion that the common stock had a value of 10c? When, as a matter of fact, the creditors were only going to receive 30c a share, that is, I mean $30, for the shares, on their indebtedness, and then before the common stockholders could share in any of the assets [84] the preferred stockholders had to share? How do you arrive at any value at all?

A. It is most difficult to arrive at any value at all. It is most difficult, Mr. Tonjes, you have stated the reason and basis why it is most difficult to arrive at that figure. The fact is, however, that there were transfers made in 1934 at 5c a share, and please remember that I had nothing to do with the setting of this price at 10c a share. I was called in in 1937. I did not know that the price had been set. They told me then that they had put the price at 10c a share on December 10, 1934, on the date of conveyance. I can tell you something more about that now, when Mr. Smith's services were authorized, if you want me to.

Q. Then those who would buy at all would be more of a speculation, or taking a chance, would it not?

(Testimony of Cassius R. Peck.)

A. Well, it is all speculation in life that makes value.

Q. Unquestionably, though, and in your estimation, wouldn't that be the motive that would make a man buy, at all, and when I say buy, I mean that common stock?

A. I think that is true.

Mr. Tonjes: That is all.

Redirect Examination

By Mr. Phillips:

Q. As a matter of fact, what you mean in 1934 I take it, [85] the Hawley Pulp & Paper was really broke, as far as the common stock was concerned?

A. Well, in 1934, I think, the last of 1934 or the early part of 1935 there was some sales of the bonds, in the thirties. And they showed an increase, when Mr. Smith was quoted the lowest prices; early in 1934, the lowest price was $17.50, but there was some come-up in that price, some considerable come-up in the price. There was some improvement in all of the prices from the time the reorganization plan got under headway. As a matter of fact, the reorganization plan was submitted first to the S. E. C., for a ruling under the S. E. C. and the reorganization was not passed and did not come along until in June, 1934, I believe, and the S. E. C. was withdrawn, as it was felt to be as a reorganization plan, coming under 77B.

Q. Would you say the stock of the Hawley Pulp & Paper would have a considerable more value in

(Testimony of Cassius R. Peck.)

the competent hands of Mr. Smith and his assistants than without them? A. Certainly.

Q. It would have more value than the management of the directors without him?

A. Not only in Mr. Smith's hands, but in the hands of any competent man, any competent management puts value into competent industry.

The Member: Well, let us get back to the cross-[86] examination.

Q. (By Mr. Tonjes) Well, the fact is,——

Mr. Tonjes: If your Honor please, at or about the time the option was granted, Mr. Smith came in and managed the organization and by that they could expect an increase and therefore the option to buy at a later date was of far more value.

The Member: This is all argumentative and has no evidentiary value at all.

Mr. Tonjes: The testimony of this expert witness, your Honor.

The Member: Are you trying to introduce in evidence Mr. Peck or are you cross-examining Mr. Peck?

Mr. Tonjes: I am just trying to find what the effect of these things would be.

The Member: Have you any further cross-examination?

Mr. Tonjes: No, I have not.

Mr. Phillips: That is all, your Honor.

The Member: Just a moment.

Mr. Phillips: I am sorry, your Honor.

The Member: Just take a few minutes. And I

(Testimony of Cassius R. Peck.)

would like to ask you, Mr. Phillips, to have the witness point out just one or two things for me.

Mr. Phillips: Yes.

The Member: Exhibit 1 is the reorganization in- [87] denture. You have the copy, don't you?

Mr. Tonjes: I would like to have one, your Honor.

Mr. Phillips: I will ask him to furnish him with a copy in the morning. I can furnish one in the morning, and I think we have one in the office.

The Member: The stock received by the Petitioner in the taxable years was received by virtue of his exercising his option which is called option "B" in the option agreement and his Exhibit 3. Now, the opton was given to Pettioner by an officer of the corporation?

Mr. Phillips: Western Cooperage Company.

The Member: He had to have something to give an option on. The point is, a part of the reorganization agreement and tie-up to the provisions in the reorganization agreement, which gave the Cooperage Company the right to receive any of the common stock of the Hawley Company, which the Cooperage Company passed on to Mr. Smith under this optional contract.

Mr. Phillips: You are referring now to Exhibit 1 and if you want to refer to the pages and section numbers——

The Witness: On page 4.

The Member: I think I will have to ask to have my exhibit, Mr. Tonjes, my copy.

(Testimony of Cassius R. Peck.)

Mr. Tonjes: Yes. I don't see how you could follow it very well without.

The Witness: On page 4, paragraph L, there is a [88] provision under which the management receives as first, first deliveries; first deliveries on common stock, is when it shall have retired, $1,400,000 of indebtedness, which was approximately half of the indebtedness of the,——

The Member: (Interposing) Wait a minute, now. Who is the management?

The Witness: Management of the Western Cooperage Company.

The Member: Then we have to go back a little bit.

The Witness: In paragraph N of the same page——

Mr. Phillips: In paragraph N, management is divided.

The Member: Well, instead of reading the provisions of the agreement itself, tell me in your own words what the plan was. Was the Cooperage Company to take over the management of the Hawley Company under the reorganization?

The Witness: Yes.

The Member: And then were they to receive either some compensation for their managerial services or a bonus, I don't know which, in the form of stock?

The Witness: Take no compensation outside of what they received in stock in the reorganization indenture.

(Testimony of Cassius R. Peck.)

The Member: But what did they receive that stock for?

The Witness: For successful management. [89]

The Member: As compensation for management?

The Witness: Yes.

The Member: I see. And you are going back to Section L. How much was the Cooperage Company to receive from that? "After a certain time the depository shall annually deliver to the management such a number of shares of second, or of said second preferred stock and/or voting trust certificates of common stock as shall bear the same ratio to the total number of shares of second preferred stock and voting trust certificates of common stock in escrow after the amount of any annual requirement of par value bonds and principal of note under the provisions of paragraphs E, F and G hereof shall bear to the $2,790,150, and provided, however, that the second preferred stock shall be first delivered,"——

The Witness: (Interposing) Which was the outstanding indebtedness, the $2,790,150, was the outstanding indebtedness, which was outstanding ahead of the stock, ahead of the first preferred, second preferred and common stock, and the obligation was as contained in the next paragraph, was to retire in bonds, $200,000 par value bonds,—or 200,000 par value bonds, during each of the years 1934, 1935, 1936, 1937, 1938, and/or after 1938 100,000 par value until all of the bonds were to be retired. Now, after that, if they were able to do that, then

(Testimony of Cassius R. Peck.)

they received their common stock. If they did not do it and fell down on the management, then the board of [90] directors were at liberty to get some other management. That is why option "B" is a bond of right to receive.

The Member: Because you could not be sure that they, in their option, that they could exercise the option on the right to receive,—they could exercise the option on the right to receive up to January 1, 1940, and how long could the management be,—how long would it be till they could be in receipt of the stock under the reorganization?

The Witness: 1940.

The Member: That is, they should have performed?

The Witness: It would be in 1940, and they should have performed then so they had all of the stock, all of the stock would have been delivered to them had they performed.

The Member: I see now, yes. Now, then, going back to the option, Exhibit "B", Mr. Smith had the right in the option to receive all of the common stock of the Hawley Company,—"the said common stock of the Hawley Company held by it in escrow and which the Cooperage Company may be entitled to receive in the proportion of six shares to the Cooperage Company, four shares to the said Smith,—until the Cooperage Company shall have received 100,001 shares and Smith 66,667," and it is peculiar to me why that figure happened to be,——

The Witness: (Interposing) Because that was

(Testimony of Cassius R. Peck.)

the amount of stock deposited under the plan,—whatever the figure, and you say there was 200,000 of shares outstanding [91] in common stock, outstanding and the Western Cooperage Company insisted upon retaining a control. Therefore they were going to retain 100,001 shares and they were not going to let Mr. Smith have control. They only received under the plan the amount of stock that was deposited under the plan.

The Member: Well, how much was deposited?

The Witness: Well, 174,378 shares.

The Member: That is provided for in the reorganization indenture?

The Witness: Well, it is not provided——

The Member: (Interposing) Not provided, well, it is,—you can't tell how much would be deposited under the broad provisions.

The Witness: No, that is true.

The Member: That is the first time that we have gotten that detail into the record.

Mr. Phillips: That is right, your Honor.

The Member: And so, following, 174,378 shares of common of the Hawley Pulp & Paper were deposited with the depository.

The Witness: Yes.

The Member: And then under option "B" the Petitioner had the right to purchase the right to the services of 100,001 shares of that 174,378 or 74,376.

Mr. Phillips: That would be 74,377, your Honor.

[92]

(Testimony of Cassius R. Peck.)

The Member: Yes. So that explains at 10c a share the 74,377 shares, being $7437.70. So how does that tie up with what we have here now?

Mr. Phillips: That was what Mr. Smith's testimony was that was included in the check. He broke the check down into two parts.

The Member: Yes. And when Mr. Smith exercised his option the stock came to him from the depository; is that right, or from the Cooperage Company?

The Witness: Upon the notification as shown by,——

Mr. Phillips: (Interposing) The notification, exhibit, shown by Exhibit 5.

The Member: That is Exhibit 5. I see. Upon giving that notification to the depository, the depository then delivered the stock to him?

The Witness: Yes.

The Member: I see. I think it is a lot better to have the mechanics explained into the record now, rather than to wait and to have the record get cold and then have to read the exhibits and reconstruct the plan.

The Witness: Yes.

Mr. Phillips: Yes.

The Member: Well, now, I think that is all I wish to ask you, sir.

The Witness: Thank you. [93]

Mr. Phillips: Thank you; that is all then. I will call Mr. Livingstone.

(Witness excused.)

The Clerk: Will you state your name for the reporter, please?

The Witness: Colin Livingstone.

COLIN LIVINGSTONE

was called as a witness for and on behalf of the Petitioner and having been first duly sworn was examined and testified as follows:

Direct Examination

By Phillips:

Q. Mr. Livingstone, you live in Portland?

A. Yes, sir.

Q. And what is your occupation?

A. I am local manager of Blyth & Company.

Q. And what business does Blyth & Company engage in?

A. The business of securities, business of investment bankers and underwriting stocks and bonds.

Q. You do underwrite stocks and bonds?

A. Yes.

Q. For yourself and customers?

A. Yes.

Q. And how long have you been engaged in that kind of work yourself? [94]

A. I have been with the firm ever since 1919.

Q. In Portland during that time?

A. In Portland since 1920.

Q. Will you go a little further and qualify—are you, for a little further qualification, are you more or less acquainted with the background and structure of the Hawley Pulp & Paper?

(Testimony of Colin Livingstone.)

A. Quite familiar, because Blyth & Company underwrote the issue and sold in 1925 or 1926, I forget exactly.

Q. You were familiar then? A. I was.

Q. And after 1925 or 1926 did you have occasion to observe the affairs of the Hawley Pulp & Paper on the market? A. Yes, certainly.

Q. And apparently you have become quite familiar with the affairs of the Hawley Pulp & Paper Company during those years?

A. Afterwards they got in difficulty and Blyth & Company lent this company $500,000, in which transaction they received a note from the company; trying to keep the bonds from falling.

Q. That is the same note referred to in the reorganization indenture? A. Yes, sir.

Q. Are you acquainted with the values of the Hawley Pulp & Paper stocks in 1934? [95]

A. Fairly. There were not many transactions at that time.

Q. Will you state then, if you please, your familiarity with their stock structures and this loan, so far as it went; will you state what in your opinion was a fair market value of the common stock of the Hawley Pulp & Paper Company in December of 1934?

A. I would say a price of somewhere between five and ten cents a share.

Q. Would you say that 10c a share would be at least equal to or exceeding the market value?

A. It would be a fair value.

(Testimony of Colin Livingstone.)

Mr. Phillips: You may examine.

Cross examination

By Mr. Tonjes:

Q. Do you base that valuation on the basis of the assets back of the stock, that is, the stockholders' equity?

A. No, because I don't think the stock had any equity.

Q. That is speculative value?

A. Absolutely speculative, yes.

Q. Yes.

Mr. Tonjes: That is all.

Mr. Phillips: That is all.

(Witness excused.)

The Clerk: Will you state your name for the reporter, [96] please?

The Witness: M. D. Carter.

Whereupon

M. D. CARTER

was called as a witness for and on behalf of the Petitioner and having been first duly sworn was examined and testified as follows:

Direct Examination

By Mr. Phillips:

Q. Mr. Carter, you live in Portland?

A. I do.

Q. What is your occupation?

(Testimony of M. D. Carter.)

A. I am in charge here for the Western Cooperage Company.

Q. And how long have you been in charge for the Western Cooperage Company?

A. Since 1908.

Q. Are the books and records of their financial accounts kept under your supervision and direction?

A. They are.

Q. Will you,—have you examined your accounts with respect to a sale to Mr. Smith of 74,000,—no, 743,770,—or $7,437.70 of common stock of the Hawley Pulp & Paper. Will you state whether or not that was reported to the books of the Western Cooperage Company as a sale of stock in 1938.

A. You mean the sale to him? [97]

Q. Yes.

A. No. It was not recorded in the sale to him.

Q. And is it recorded as a sale?

A. Well,——

Mr. Tonjes: (Interposing) I object to the question, your Honor, as not being material. The books of the Western Cooperage Company are in no way binding upon the Respondent or this Board as to whether or not this constituted a sale at that time.

The Member: What is the purpose of that question?

Mr. Phillips: The purpose of the question, your Honor, is that in 1938 the Western Cooperage Company made this transfer of the right to receive to Mr. Smith, at least by an actual option, by virtue of receiving the money from Mr. Smith of this

(Testimony of M. D. Carter.)

74,000-odd and it is a theory of the Government that is income received by Mr. Smith during 1938 and 1939 and I want to further follow these questions to show that there was no increase in the operation expense by reason of this amount or a deduction on their income tax returns by reason of compensation paid to Mr. Smith in connection with this and they have been audited by the Internal Revenue agents or the representatives of the Internal Revenue Department and no deduction,—if their theory is correct, there is none for income in 1939 or 1938 to Mr. Smith for services. On the other hand the Western Cooperage Company would be entitled to a further [98] deduction by reason of operating expense and if your Honor please, we want to show, I mean, they have audited the books——

The Member: (Interposing) Well, it is argumentative. I will overrule the objection.

The Witness: I don't understand the question.

The Member: I think it ought to be reframed.

Mr. Phillips: Well, probably it would be better.

By Mr. Phillips:

Q. Did your books reflect receipt of money from Mr. Smith in 1938 in payment of common and second preferred stock? A. They did.

Q. And in the year 1938 was there any reflection in the records of the Western Cooperage Company of any income or salary or compensation paid to Mr. Smith which in any way reflected the value,—

(Testimony of M. D. Carter.)

market value, or any other value of this common and second preferred stock? A. No.

Q. Was there any deduction taken in any way in their income tax return for 1938 or 1939?

A. There was not.

Q. Representing any form of compensation to Mr. Smith by reason of his purchase of this stock?

A. No, there was not.

Q. Were your returns audited by the Income Tax Unit for 1938 and 1939? [99] A. Yes, sir.

Q. Now, just one other question. This amount of money that you received for this second preferred and the common stock, including $7434.70, which you received, and common stock, was that included and reflected in your income for the year 1938, if any part of it was income to the Western Cooperage Company?

Mr. Tonjes: You mean 1938?

Mr. Phillips: Yes, that is when they received it.

The Member: Read the question, please.

Mr. Tonjes: Yes, will you read that, please?

(Question read.)

The Member: Wait a minute, now. Let us reframe that whole question. You are referring to the 11,000-odd dollars, aren't you?

Mr. Phillips: Well, I will reframe the question and,——

By Mr. Phillips:

Q. Will you state whether or not the amount of money which you received from John H. Smith in 1938 in payment of the common stock was reflected

(Testimony of M. D. Carter.)

in the income of the Western Cooperage Company and if any part of it was income, was it returned as income? A. Yes.

Mr. Phillips: I think that is all I have. [100]

Mr. Tonjes: No questions.

The Member: Well, now, I wonder if the witness could answer a few questions that might be a little difficult to answer without the books.

Mr. Phillips: I will find out.

By Mr. Phillips:

Q. Do you have your books with you?

A. No, I have not. I have the journal entries on the right to receive.

The Member: Well, before I ask the questions, I will discuss the problem with counsel. I don't know just how the question in this case will finally have to be analyzed, but the Respondent's position, of course, is that the Petitioner received some compensation from the Cooperage Company when he received stock, which had a fair market value in excess of the consideration that he was to pay for it. We understand that, I believe. Now it occurs to me that from an accounting standpoint it is along the same thought that you had a few minutes ago, if Mr. Hawley received.——

Mr. Phillips: (Interposing) Mr. Smith, you mean.

The Member: (Continuing) ——if Mr. Smith received compensation in 1938 in the amount of the difference of the market price and the considera-

(Testimony of M. D. Carter.)

tion that he gave, which is a pretty large amount in 1938, the 74,000-odd dollars, the Cooperage Company had to, in some way, turn over something to [101] him that was carried on their books which would in some way or other carry a bookkeeping entry of that amount. Now, supposing Mr. Smith had performed, we will take another kind of a case, a hypothetical case, and supposing Mr. Smith had performed some unusual services for the Cooperage Company and it had been agreed that he would receive some compensation for those services in stock of the Cooperage Company, in treasury stock of the Cooperage Company. Now, that stock would be carried on the books of the company, wouldn't it? It would be carried on some value on the books of the company. Now, this question does come up in some cases where an employee is paid in stock of the company he is working for. The company may have acquired its own stock at an earlier date, at a lower price than it was issued at the time it was given to the employee, or it may be agreed that the stock be given to the employee at a reduction price.

Mr. Phillips: At a reduction price, and then you have compensation,——

The Member: (Interposing) Then how near is this case from that one or how far away is it? Now, to get at that I would like to know and, this is all preliminary to asking this accountant to give us the answer, how was the Hawley stock carried on the books of the Petitioner if it was at all?

(Testimony of M. D. Carter.)

Mr. Phillips: You mean of Petitioner's?

The Member: No, on the books of the Cooperage Company, [102] if it was carried on the books of the Cooperage Company at all. The point I want to be sure about is this: Now, the circumstance under which the Cooperage Company was to receive this stock was rather unusual. Cooperage Company went in as a new manager under a plan of reorganization. The Cooperage Company was not an owner of this stock. It did not acquire the stock or anything like that. The way in which the Cooperage Company got the stock is purely for the,—in the reorganization agreement. It is fully set forth in the reorganization agreement and after all the reorganization and the Cooperage Company had acquired the stock in the company, how was that stock carried on the books of the Cooperage Company; and then when we get that information there is to be a bookkeeping entry when that stock was transferred from the Cooperage Company to the Petitioner.

Mr. Phillips: Of course, they did not actually receive the stock, the receipt of the stock and the transfer to Smith, as far as the transfer that took place, that took place at the same time the authorization for the depository to make the transfer took place, all at the same time. And they received,—what they received was compensation to the Western Cooperage Company.

The Member: What did he receive?

(Testimony of M. D. Carter.)

Mr. Phillips: As management. They received the 100,001 shares. [103]

The Member: The Cooperage Company received 100,001 shares?

Mr. Phillips: That is what I had reference to in the 174,378 shares.

The Member: Well, they received that as compensation for their management services.

Mr. Phillips: Yes.

The Member: If they had not made this agreement with Petitioner they would have received all of the stock, or the 174,378 shares, is that right?

Mr. Phillips: Yes, but they agreed to sell it and made their agreement with Mr. Smith on December 10, 1934, at the then market value or in excess of the then market value, and that is what distinguishes this case from the case you have referred to, where a corporation actually sells outright to an individual stock at a reduced value because it is in compensation for some service. Now, that is compensation received by an employee. Now, Mr. Smith received what you might call a negligible compensation by receiving these,—or this option. Nobody at that time knew whether it had any value or not. We,—certainly, nobody placed any value on it. It was just a pure gamble, you might say, from then on, from then on out, but that is what he received in stock, just the option, an opportunity to buy the stock at what was then in excess of a fair market value; and when you have a contract [104] like that; it is just the same as if

(Testimony of M. D. Carter.)

you made it with a pure stranger, because the question of an employee goes out of the picture, it is just an instrument and I,——

The Member: (Interposing) The price was fixed.

Mr. Phillips: (Continuing) The price was fixed and he had the rights to purchase under the terms of that option, just the same as if it were made with a pure stranger; and that is the distinction, as you take where they have held there have been compensations, or direct dealings for services, and there have been many of those cases, but the option cases are different and two of them went to the Circuit Court and we will give your Honor the benefit of those cases and several of the Board members have distinguished the options.

The Member: Well, then I suppose there really is some point to be given,—some consideration probably has to be given to the particular way in which this agreement was worded and if, as counsel has pointed out, whether or not the option was to purchase Cooperage's right to receive certain common stock,——

Mr. Phillips: (Interposing) Yes, well, and——

The Member: (Interposing, continuing) It was not,—under the strict wording of the option, the contract did not give Mr. Smith the right to purchase a certain amount of the Hawley Cooperage common stock from the,—or I mean the Hawley Pulp & Paper common stock from the Cooperage Company [105] at a certain price?

Mr. Phillips: No.

(Testimony of M. D. Carter.)

The Member: If the contract had been in those terms, then Mr.,—well, I don't know whether it would make any difference in this case or not. Mr. Smith would be buying something for a fixed consideration.

Mr. Phillips: For a fixed consideration, yes.

The Member: Which, at the time, the property might have a value greatly in excess of the consideration.

Mr. Phillips: And of course that would go to his heirs and assigns in 1937, he could assign this agreement,—or contract to purchase and he would have the same consideration and he would have the right to buy under the same terms, whether he were an employee of the Cooperage Company or not.

The Member: Well, there is quite a lot of discussion on the record, but it clarifies somewhat the record to me, I believe. Now, about getting back to the question of the witness to be asked. I suppose my question would not be proper now because the Cooperage Company would not have carried an account on its own books,——

The Witness: (Interposing) Well, if your Honor please, I have a copy of my entry and if I may get it in——

The Member: Well, just let me ask a question. Will you describe what kind of entries were made in the books of the Cooperage Company, describe the transaction between the [106] Cooperage Company and Mr. Smith. That is, the receipt from Mr. Smith, by him, from the company, and the

(Testimony of M. D. Carter.)

transfer of something,—of something from Smith. Now, it is at that point that I wonder what kind of an entry you would make on your books to show what receipt of money from Mr. Smith, what would be the offsetting entry against that, what about that?

The Witness: When Mr. Smith gave us a check, of course, we made a debit to cash account and credited an account which we called John H. Smith Investment, until he should exercise his option.

The Member: What did you call it?

The Witness: John H. Smith Investment. We did not give him anything yet, in other words, he had put this money up to exercise an option. Well, a short time later, he got the stock and we paid off that again and it was simply an expense account until this happened. Then, we paid off this account and I made two entries, one debited to John H. Smith Investment Account and profit and loss credit, $7437.70, that is, for the right to receive sold to John H. Smith for the said right to receive certain stock of the Hawley Pulp & Paper and, that is, 74,277 common shares of the same and that was the entry for that, where I got that.

The Member: Well, I don't understand that very well, and I think you ought to put that in evidence. There seems to be a pretty good entry showing the descriptions of the terms [107] of their,—over the option.

Mr. Phillips: I am perfectly willing to put it in evidence, if Counsel has no objection.

(Testimony of M. D. Carter.)

The Witness: Is that all?

Mr. Tonjes: Well, if your Honor please, I think we ought to have all the records in here if we are going to have any portion, they are not complete, and unless they are complete it will be misleading.

The Member: What do you mean, they are not complete?

Mr. Tonjes: Well, I mean,—what I mean is this, when the Western Cooperage received stock of the Hawley,——

The Member: (Interposing) It never did.

Mr. Tonjes: Oh, I think it did, your Honor.

The Witness: It did not receive that.

Mr. Tonjes: Not the shares that Mr. Smith got, but it received shares under the management contract.

The Member: Well, now, Mr. Tonjes, that is just exactly why I have been having this discussion with Counsel for Petitioner, I want the record to be perfectly clear on the point.

Mr. Tonjes: So do we, your Honor.

The Member: Whether or not the stock that Mr. Smith received was received from the Cooperage Company. Now, the records so far I believe fairly show that the Cooperage Company was entitled to receive directly under the management contract [108] after the option agreement was made with Mr. Smith 100,001 shares of common stock, that was to go directly to the Cooperage Company from the depository, which was from the California Bank, the Bank of California.

(Testimony of M. D. Carter.)

Mr. Tonjes: I think that is right.

The Member: Now, the Cooperage Company was never to receive stock in excess of 100,001 shares, unless Mr. Smith failed to exercise his option.

Mr. Tonjes: That is correct.

The Member: So that the depository would retain the excess stock up to the end of the option period, or January 1, 1940. Prior to January 1, 1940, Mr. Smith exercised the option; gave notice to the depository and the depository delivered the stock that we are concerned with here directly to Mr. Smith.

Mr. Tonjes: That is correct.

The Member: That stock never went to Western Cooperage Company.

Mr. Tonjes: That is correct.

The Member: Now, that bookkeeping entry, if I may see that,——

Mr. Tonjes: (Hands document to member.)

The Member: (Continuing) ——is a journal record and as I understand it, this describes the only places where other entries were made to cover the transaction. That is, [109] the other entries to be made here in the,—were in the profit and loss account only. Profit and loss account and John H. Smith Investment. These were the only entries that could be made.

Mr. Tonjes: No, your Honor, more entries should be made and were made. The Cooperage

(Testimony of M. D. Carter.)

Company received for its own use 50,539-1/24 shares which it reported as income.

Mr. Phillips: That is right.

Mr. Tonjes: And that is a proper entry. Now, had it entered, had it not entered into this contract with Mr. Smith it would have been entitled to receive the 166,000, which it reports, plus the value of the shares that were given to Mr. Smith, but not having reported them,——

The Member: (Interposing) Well, I don't know where you are getting this information.

Mr. Phillips: That is the,——

The Member: (Interposing) Just a minute.

Mr. Phillips: Excuse me.

The Member: Where do you get that information, Mr. Tonjes?

Mr. Tonjes: You stated that there were not more entries that were necessary. I am pointing out that more are necessary to reflect the entire transaction.

The Member: Now, I am trying a case and am trying to make a record. Now, if I,—everything I have said into [110] the record is a summary of the evidence that is into the record. Now, you are talking about a lot of things, and where did you get your information?

Mr. Tonjes: You asked about the necessary entries and,——

The Member: (Interposing) Would you mind telling me where you got all this from?

Mr. Tonjes: From the testimony introduced that

(Testimony of M. D. Carter.)

the,—or to the effect that the Western Cooperage Company received in 1938 the shares from the depository at the same time that Mr. Smith received his.

The Member: Just a moment, please. Off the record.

(Discussion off the record.)

The Member: In 1938 the Bank of California, depository, was instructed by the Western Cooperage Company to deliver following trust certificates representing 50,339-1/24 common stock of Hawley Pulp & Paper to the Western Cooperage Company. That is, to itself. And to deliver to Mr. Smith 33,769 shares. Now, do you recall what kind of an account was carried on the books of the Cooperage Company to reflect its receipt or right to receive the Hawley Company stock under the plan of reorganization?

The Witness: Yes. I charged the stock that we got in 1938 to stock in other companies,—in the Western Cooperage, I mean, $50,000, 50,000-odd shares. The other, [111] we did not receive and I understand we had no right to receive it because we had sold the right to receive it, so we did not record the stock Mr. Smith received, and had we recorded it on our books we would have had a straight-out sale, and then we would have reflected the difference, or, as a loss, between the fair market value and the ten cents a share.

The Member: Well, you don't need to go beyond my question. I did not want to know why

(Testimony of M. D. Carter.)

you had done it, I will ask you another question as to that. Now, would your explanation, Mr. Phillips, that this journal entry that we were discussing a few minutes ago being charges to profit and loss accounts and the John H. Smith investment account and whatever account was kept to show the receipt of stock from the depository, would constitute the entire bookkeeping record?

Mr. Phillips: Yes, that would be,—that is, that would be a reflection in the profit and loss account and of course the other question, on the other hand, I asked, I believe, but there was no deduction in their tax return by reason of deduction, or compensation, of this tax, for Mr. Smith. But the item does not go in as an operating expenses of the company, if it was compensation.——

Mr. Tonjes: (Interposing) As a matter of fact, the effect was the same.

The Member: Well, just a moment. Let me see if I can get this straight. After the company,—if they treated [112] the transaction as a sale of an intangible right, then they must have made an entry to show they had an asset to receive some intangible right. Wouldn't they? How did they set up the intan—you pointed out that for purposes of your bookkeeping entries a sale had been made to Mr. Smith of the right to receive a certain amount of stock. That intangible right. Now, how did you set that right up as an asset on your books?

The Witness: I did not make any entry recording of our right to receive at the beginning of the

(Testimony of M. D. Carter.)

reorganization indenture. There was nothing made on my books until something transpired.

The Member: There is no receipt,——

The Witness: (Interposing) Or there had been received the stock of the Bank of California.

The Member: Then when did you receive Mr. Smith's check? When you did, you then carried some tangible account,—$7437.37, which was the exact amount of his check?

Mr. Phillips: No, that is,——

The Witness: (Interposing) We showed that, and the one percent profit, and put it in our profits; we sold something that cost nothing, as far as the books were concerned.

The Member: As far as the books were concerned?

The Witness: Yes, sir.

As far as the books were concerned; so we have nothing [113] to do except take that into our profits.

The Member: That's right. Well, I am not a very good accountant and I wanted you to explain that.

Mr. Phillips: May I explain the income or compensation, the income on compensation that the Western Cooperage Company received in 1938 for management. 50,939½ shares of common stock, plus $7437.70, that was their compensation that was received for management during that year.

The Member: Well, I think that explains it. I

(Testimony of M. D. Carter.)

would like to have that in evidence, if you would offer it.

Mr. Phillips: We will offer it in evidence.

The Member: If you can have another copy made.

Mr. Phillips: I think I can make a couple of copies and we can have them tomorrow.

The Member: Well, that will be received in evidence as Petitioner's Exhibit 7.

(Whereupon the document above referred to was marked Petitioner's Exhibit 7 and received in evidence.)

PETITIONER'S EXHIBIT No. 7

[Pencil Notations on face of exhibit]: 100 001 — 66667
Mar 21 '38—Sp. Ledger Cr. 11180.70 Red #1
Cr JHS Invest. 2nd 7487 2/3

JOURNAL 1938 216

December 12, 1938

John H. Smith—Inv. 7,437.70
Profit & Loss—1938 ..... 7,437.70

Sold to John H. Smith certain Intangibles consisting of our right to receive certain stock of Hawley Pulp and Paper Co.—ie 74377 shares common stock (See minute Records Book 5, Page 201).

John H. Smith—Investment 3,743.00
Stock in Other Companies 3,743.00

3743 shares of Hawley Pulp and Paper Co. 2nd Preferred Stock sold to John H. Smith under option (See Minute Book No. 5, page 200).

[Endorsed]: Filed U.S.B.T.A., Sept. 17, 1942.

(Testimony of M. D. Carter.)

Mr. Tonjes: Is that all?

The Member: That is all I have.

Mr. Phillips: That is all.

Cross Examination

By Mr. Tonjes:

Q. Did you make any entry on your books of account in 1938 recording the receipt of any of the stocks which were de- [114] livered to Mr. Smith from the depository? A. No.

Q. You recorded the amount which was received by the company at $2.50 a share? A. I did.

Mr. Tonjes: That is all.

Mr. Phillips: That is all. That completes our testimony on the first issue and if your Honor please, if you like, I would call Mr. Smith back on the little issue of the San Juan Mining Corporation.

The Member: Well, let us take a recess.

(Short recess.)

The Member: I might say for the record that I think that when the Revenue agent, in auditing the returns of the Cooperage Company, saw the entry on the books of the ,—reflecting the receipt of the 30,000-odd shares, which the Cooperage Company is entitled to receive from the depository at $2.50 a share. I suppose the delivery immediately started, you see, at least, the stock that Mr. Smith had received. I think the question in the case still may turn on just exactly what did Mr. Smith receive, what did his contract with the Cooperage

Company amount to? Did he purchase the right to receive the stock or did he receive?

Mr. Phillips: Well, I probably should have brought the Cooperage Company returns. [115]

Mr. Tonjes: I have the returns.

Mr. Phillips: As I recall, he had a description of the whole thing in it, of the option, and everything else.

Mr. Tonjes: I have the returns, the return of Mr. Smith and these returns, and we are on the record now, are we, your Honor?

The Member: Yes.

Mr. Tonjes: I have the returns.

The Member: Well, I think probably, Mr. Tonjes, the Cooperage Company return ought to be in evidence. Only, for the purpose of showing the whole transaction, not for anything else than the return.

Mr. Phillips: Well, most of the return would not be relevant to the issue anyway.

The Member: No.

Mr. Phillips: And it also reports here in schedule E the entire extract of the minutes of the corporation, the entire resolution we have in full, of the 1938 return.

Mr. Tonjes: You want to put them all in evidence?

Mr. Phillips: Well, that would be the part that would be the most material, because they show the sale of their right to receive the 74,377 shares and show that item in their—as a gain.

Mr. Tonjes: Yes. They report the 70,000-odd, no question about that. [116]

Mr. Phillips: Yes, and they report the whole resolution on the option.

The Member: Well, I think you better put the return in evidence.

Mr. Phillips: We are quite willing to put the return in evidence.

The Member: Respondent will have to offer it, I think, because it is their return.

Mr. Phillips: Yes, it is their return.

Mr. Tonjes: Respondent offers in evidence the income tax return of the Western Cooperage Company for the year 1938.

The Member: That is received as Respondent's Exhibit A with leave to withdraw the return and substitute photostat copies of so much thereof as is material.

Mr. Phillips: Yes. I understood it was to be received,—only those portions as are material.

Mr. Tonjes: Yes. And we have the 1939 return; we should like to offer this.

The Member: I should like to ask for a little bit more enlightenment on this. I have been trying to follow the evidence as closely as I can and make some notes, now, and I understand it was in 1938 that Mr. Smith gave his check for $11,180.70 to the Cooperage Company.

Mr. Phillips: That is right, your Honor.

The Member: And that was, of that was $7,437.70. [117]

Mr. Phillips: That is right.

The Member: With the right to receive 74,377 shares of stock.

Mr. Phillips: Common stock.

The Member: Common stock, and in 1938 the Cooperage Company directed the depository to deliver to Mr. Smith out of everything he is entitled to receive, I suppose, that would be 73,579 shares of common stock; now, in 1939, the next taxable year, Mr. Smith received some 12,000 shares more of common stock, but in 1939 the Cooperage Company did not receive any consideration from Mr. Smith and so it would not have anything in its return to,—would not have to show anything in its return in the income. So I can't see where the 1939 return is material.

Mr. Phillips: Well, I don't think the 1939 return is material at all as far as we are concerned with the issues here.

Mr. Tonjes: It would show, your Honor, that the Western Cooperage Company did not report any more than the amount that it had gotten in, —that is to say, the amount to which it was entitled for its management, less the amount it had previously sold to Mr. Smith. I think that is material. In other words, the company,——

The Member: (Interposing) Well, that can be stipulated. [118]

Mr. Tonjes: If Counsel will stipulate it, I will gladly do so.

Mr. Phillips: Yes, we will stipulate that.

Mr. Tonjes: That is satisfactory.

SCHEDULE E FROM INCOME TAX RETURN OF WESTERN COOPERAGE CO. FOR 1939

Western Cooperage Co.
Portland, Oregon
1938

Schedule "E" for Line 13, Page 1—

CAPITAL GAINS AND LOSSES

Description of Property	Date Acquired	Gross Sales Price	Cost or Other Basis	Gain or Loss
Seattle Orpheum Bonds	12/ 7/27	6,209.70	15,000.00	8,790.30
Hawley Pulp and Paper Co. Bonds	1/30/28	1,821.31	2,020.00	198.69
" "	12/29/37	150,051.40	150,051.40	—
" "	1/24/38	34,765.25	34,765.25	—
Sale of our right to receive 74377 Shares Common Stock of Hawley Pulp and Paper Company	1934 to 1938	7,437.70	*Nil	7,437.70
				1,551.29

*Under reorganization of Hawley Pulp and Paper Company we earn right to receive certain stock. Right to receive 74,377 shares sold for cash.

Extract from minutes of special meeting of the Board of Directors of the Western Cooperage Co., held on May 4, 1937:

"Be It Resolved that the act of the President of this corporation on December 10, 1934, in giving to John H. Smith, in consideration of his services theretofore rendered in negotiating the plan of reorganization of Hawley Pulp and Paper Company and in bringing about the deposit of securities enabling the confirmation of said plan by decree of the District Federal Court of Portland, Oregon, an option

"(a) To purchase, at a price of $1.00 per share which was the then fair market value thereof, 3743 shares of Second Preferred Stock of the Hawley Pulp and Paper Company deposited by the Cooperage Co. under said plan; such option to be void unless exercised within a period of 60 days after the return of said Second Preferred Stock to the Cooperage Co; if said option should be exercised by the said Smith before the return of said stock to the said Cooperage Co. the said Cooperage Co. would file with the Depositary holding said Second Preferred Stock in escrow under the terms of said reorganization plan, a written order directing the said Depositary to deliver, when the Cooperage Co. should be entitled to the return of said stock under the terms of said reorganization plan, to the said Smith said stock as purchased by him in the exercise of said option; and

"(b) To purchase on or before January 1, 1940, at a price of $7437.70 the right to receive all common stock of the Hawley Pulp and Paper Company in excess of 100,001 shares to be received by the Cooperage Co. in the performance of its management contract referred to in said plan of reorganization; because of the possibility that the Cooperage Co. may be entitled to receive only a portion of the stock placed in escrow under the said reorganization plan and not be entitled to receive all such stock by reason of management default, then, in case said Smith exercises his said option, the Depositary holding the common stock in escrow under the terms of said reorganization plan be given

a written notice by the Cooperage Co. that it had sold its right to receive 74377 shares, accompanied by a written order to deliver the common stock of the Hawley Pulp and Paper Company held by them in escrow at the ratio of six shares to the Cooperage Co. and four shares to John H. Smith until the Cooperage Co. had been thus delivered 100,001 shares and John H. Smith approximately 66667 shares and thenceforth deliver the balance of approximately 7710 shares held in escrow to John H. Smith; all such deliveries to be made by the Depositary when the Cooperage Co. has earned the release of stock by the Depositary as set forth in the said reorganization plan.

"Be It Further Resolved that the executive officers of this corporation be authorized and directed on behalf of this corporation to execute and deliver, as of the 10th day of December, 1934, to John H. Smith, a formal option substantially setting forth the option and the terms and provisions thereof as hereinbefore in this resolution recited."

The Option Referred to Above Was Exercised by Mr. John H. Smith March 31, 1938 and Cash Paid as Provided in the Option.

The Member: Well, then we can go on to the next issue if you are satisfied.

Mr. Tonjes: The only point is, your Honor, because Counsel earlier made some remarks the corporation did not get the benefits of this, because of deduction.

The Member: Well, that was an argument that Counsel for Petitioner was making. It had no probative value. It was not a matter of evidence. He can make that answer in a brief, you can answer, and if it is in the record you can take care of it then.

Mr. Tonjes: Very well. I did not presume that Counsel would make the remark unless he believed it to be a fact. It was not the fact.

Mr. Phillips: There was not in the accounts posted to show there was no additional compensation to Mr. Smith by reason of this option in 1938, or that there was any deduction taken by way of salary by reason of this compensation to Mr. Smith in 1938, and that is all I wanted to show.

Mr. Tonjes: I see.

Mr. Phillips: I will call Mr. Smith again.

Whereupon, [119]

JOHN H. SMITH

was recalled as a witness on his own behalf, being previously duly sworn, and testified further as follows:

Redirect Examination

By Mr. Phillips:

Q. Mr. Smith, with respect to the San Juan Syndicate, Mining Syndicate, will you explain to the Board when you purchased an interest in that Syndicate?

A. That is such a small transaction I would have to refer to something.

Q. Well, you took a loss for it on your 1939

(Testimony of John H. Smith.)

income tax return; to refresh your memory, I will hand you a copy of your 1939 return if that is of assistance to you. I think under Schedule F you will find a notation with respect to Schedule F on page 2 of the yellow or green sheet.

A. I don't keep,—I see the entry here was evidently purchased on July 17, 1937, and I have no reason to question it.

Q. Well, what I meant, did you have invested in the San Juan Mining Syndicate, how much?

A. $1,000.

Q. And who was the chairman of the San Juan Mining Syndicate? A. Paul C. Bates.

Q. And did you receive information from Mr. Paul C. [120] Bates in 1939 relative to the dissolution of this syndicate? A. I did.

Q. In the purchase of this,—let me say, did you actually pay a thousand dollars for your interest in the syndicate?

A. Yes, I paid a thousand dollars.

Q. I will hand you a letter from Mr. Bates, chairman of the San Juan Mining Syndicate in 1939, and one attached, addressed,—Dated April 6, 1939, addressed to Mr. Getchell of Idaho, and is that the signature of Mr. Bates (indicating document to witness)? A. It is.

Q. Are you familiar with his signature?

A. I am.

Q. And was 1939 the first time that you were advised that that corporation,—or, rather, the San

(Testimony of John H. Smith.)

Juan Mining Syndicate was being dissolved?

A. That is correct.

Mr. Phillips: We will offer in evidence these letters; any objection?

The Member: Is there any objection?

Mr. Tonjes. No objection.

The Member: Received as Petitioner's Exhibit 8.

(Letter referred to marked Petitioner's Exhibit 8 and received in evidence.) [121]

Mr. Phillips: That is addressed to the members of the San Juan Mining Syndicate and,——

By Mr. Phillips:

Q. Did you receive any money or profit of any kind whatsoever by reason of the liquidation of this syndicate? A. Never did.

Q. Never did? A. No.

Q. As far as you know it is washed up and done? A. That is right.

Q. And you have been so advised by Mr. Paul C. Bates by letter? A. That is correct.

Mr. Phillips: You may examine.

Recross Examination

By Mr. Tonjes:

Q. Mr. Counsel,—it is stated on the record the exact date of the purchase. Yes, he stated it as July 17, 1937.

Mr. Phillips: Yes.

A. Yes.

Mr. Tonjes: That is all.

The Member: I don't understand the Peti-

(Testimony of John H. Smith.)

tioner's position with respect to this item. The Commissioner does not question the Petitioner sustained a loss, but the Respondent has limited the loss under the capital gains and [122] loss provision of the statute. He allowed the taxpayer a deduction of $500.

Mr. Phillips: They attempt to limit his loss to 50% or $500. He claims, whatever,—he is entitled to $666.66 and we are claiming in our petition we are entitled to an ordinary loss on this transaction of $450 because of worthlessness. This is our contention. Let me ask one more question.

The Member: Because there was no sale or exchange?

Mr. Phillips: Because there was no exchange and no liquidation remaining.

Redirect Examination

By Mr. Phillips:

Q. Did you charge off on your books, Mr. Smith, all interests in the San Juan Mining Syndicate?

A. Yes.

The Member: The Petitioner now claims $1,000 as an ordinary loss?

Mr. Phillips: $1,000 as an ordinary loss by reason of worthlessness.

The Member: How did the taxpayer compute $666 in his return?

Mr. Phillips: I don't know why he did, and I don't know why the Commissioner asked 50%. I think you miscomputed your time of holding there between 1937 and 1939. [123]

(Testimony of John H. Smith.)

The Witness: I presume so. I don't know anything about the time on it now.

The Member: Well, the Commissioner rules there had been a loss on 50% instead.

Mr. Phillips: And we now take the position that he was entitled to the full 100% as of an ordinary loss.

The Member: I don't know but what that seems to be correct.

Mr. Tonjes: I don't think it is, your Honor.

The Member: There is no sale or exchange, the capital provision applies only to sale or exchange of capital assets. I think that is correct. Do you have anything further, Mr. Tonjes?

Mr. Tonjes: Offhand I can't say. I have gone into the law point, your Honor, but now offhand I can't say anything further at the moment, I guess.

The Member: All right.

Mr. Phillips: The Petitioner rests.

Mr. Tonjes: Respondent rests.

The Member: All right. I think we will have simultaneous briefs. I think that will be all right in the,—the first briefs will be due November 2 and reply briefs will be due November 17.

Mr. Tonjes: May I have leave of filing a reply, rather than an opening brief. I would rather, if it would [124] suit your convenience.

The Member: No, I want you to brief the case, Mr. Tonjes.

Mr. Tonjes: Very well.

(Whereupon, at 10:40 p. m., the hearing was concluded.)

[Endorsed]: U.S.B.T.A. Filed Oct. 14, 1942.

[125]

In the United States Circuit Court of Appeals for the Ninth Circuit

Tax Court
No. 110050

JOHN H. SMITH,

Petitioner on Review,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent on Review.

PETITION FOR REVIEW

To the Hon. Judges of the United States Circuit Court of Appeals for the Ninth Circuit:

John H. Smith, Petitioner in the above cause, does hereby petition the United States Circuit Court of Appeals for the Ninth Circuit to review the decision of the tax court of the United States entered on April 7, 1943, ordering and deciding that there are deficiencies in income tax due from the taxpayer, John H. Smith, the Petitioner on Review, for the calendar years 1938 and 1939 in the respective amounts of $33,502.64 and $29,446.16. Taxpayer John H. Smith filed his Federal income tax returns for the calendar years 1938 and 1939

with the Collector of Internal Revenue for the District of Oregon, whose office is located at Portland, Oregon, and within the Judicial Circuit of the United States Circuit Court of [148] Appeals for the Ninth Circuit. The taxpayer, John H. Smith files this petition pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code.

Nature of Controversy

Prior to December 10, 1934, the Petitioner, John H. Smith, rendered certain services in connection with the reorganization of Hawley Pulp and Paper Company. On December 10, 1934, in consideration of the services rendered prior thereto, Western Cooperage Company gave to the Petitioner an option to purchase, on or before January 1, 1940, at a purchase price of ten cents per share, the right to receive all of the Common Stock of Hawley Pulp and Paper Company in excess of 100,001 shares to be received by the said Western Cooperage Company. The purchase price of said stock as fixed in said option was not less than the market value of the said stock or the voting trust certificates representing said stock on December 10, 1934. This option was subsequently ratified and approved by the Board of Directors of Western Cooperage Company. Thereafter, in March of 1938, the Petitioner, John H. Smith, exercised his right under said option and purchased from Western Cooperage Company voting trust certificates representing 74,377 shares of Common Stock of Hawley Pulp and Paper Company. The said purchase

was [149] made pursuant to and in accordance with the terms of said option agreement. That the purchase price was 10 cents per share, or a total purchase price of $7,437.70. The said purchase price was paid by Petitioner to Western Cooperage Company during the calendar year 1938. During the calendar year 1938, in accordance with instructions given by Western Cooperage Company to the depository holding said voting trust certificates, there was delivered to the Petitioner, John H. Smith, under the terms of said option, voting trust certificates representing 33,759 shares of Common Stock of Hawley Pulp and Paper Company.

That during the calendar year 1939, in accordance with instructions given by Western Cooperage Company to the depository holding said voting trust certificates, there was delivered to Petitioner John H. Smith, under the terms of said option, voting trust certificates representing 12,374 shares of the Common Stock of Hawley Pulp and Paper Company.

The Petitioner received the option to purchase the right to receive said stock or voting trust certificates representing said stock on December 10, 1934. At that time the option had no more than a nominal value and no return thereof was made in the income tax return [150] of John H. Smith for the calendar year 1934. No additional income was reported by the Petitioner, John H. Smith in the calendar years 1938 and 1939 by reason of the purchase of said stock under said option.

The Commissioner of Internal Revenue assessed

deficiencies in income tax for the year 1938 in the amount of $33,502.64, and asserted deficiency in income tax for the year 1939 in the amount of $29,444.39, which the Commissioner claimed to be a tax upon the difference in the amount paid for the voting trust certificates by the Petitioner, John H. Smith, and the alleged amount of their fair value at the time of the delivery of said voting trust certificates to the Petitioner, John H. Smith.

The Petitioner, John H. Smith, in his income tax return for the year 1939, claimed a loss on account of worthlessness of four units of interest in San Juan Mining Syndicate, which Petitioner John H. Smith had purchased on July 17, 1937 for the sum of $1000.00. The Petitioner in his return claimed a loss of $666.66 on account thereof. The Commissioner of Internal Revenue claimed that as a capital loss the amount thereof could not exceed $500.00. Before the United States Tax Court the Petitioner claimed a full loss of $1000.00 by reason [151] of worthlessness of his investment in the Syndicate.

The United States Tax Court held that the Petitioner, John H. Smith, had received income representing the difference between the option price of the voting trust certificates and the fair market value thereof during the calendar years 1938 and 1939, and that the loss on the units of San Juan Mining Syndicate was a capital loss and limited to $500.00. Accordingly, the Tax Court of the United States decided that there were deficiencies in income tax liability of John H. Smith, Petitioner.

for the years 1938 and 1939 in the respective amounts of $33,502.64 and $29,446.16.

/s/ JOHN H. SMITH,
/s/ CLARENCE D. PHILLIPS,
Attorney for Petitioner on Review.
GRIFFITH, PECK, PHILLIPS & NELSON,
Counsel.

[Endorsed]: T. C. U. S. Filed May 19, 1943.

[152]

[Title of Circuit Court of Appeals and Cause.]

NOTICE OF FILING PETITION FOR REVIEW

To J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, Washington, D. C.

You are hereby notified that John H. Smith, the Petitioner above named, did, on the 19th day of May, 1943, file with the Clerk of the Tax Court of the United States, at Washington, D. C., a Petition for Review by the United States Circuit Court of Appeals for the Ninth Circuit of the decision of the Tax Court heretofore rendered in the cause of John H. Smith, Petitioner, vs. Commissioner of Internal Revenue, Docket No. 110650. A copy of the Petition for Review as filed is hereto attached and served upon you.

Dated this 24th day of May, 1943.

CLARENCE D. PHILLIPS,
Attorneys for John H. Smith,
Petitioner.
GRIFFITH, PECK, PHILLIPS
& NELSON,
Of Counsel. [153]

Service of the above and foregoing notice, together with a copy of the Petition for Review mentioned herein is hereby acknowledged this 29th day of May, 1943.

(S) J. P. WENCHEL,
Chief Counsel.

By .....
Counsel for Respondent on
Review.

[Endorsed]: T.C.U.S. Filed June 9, 1943. [154]

[Title of Circuit Court of Appeals and Cause.]

STATEMENT OF POINTS TO BE RELIED UPON

Comes now the Petitioner on Review herein, and makes this concise statement of points on which he intends to rely on the review herein, to-wit:

The United States Tax Court erred as follows:

1. In holding and deciding that the Petitioner, John H. Smith, received additional income during the calendar year 1938.

2. In holding and deciding that the Petitioner,

John H. Smith, received additional income for the calendar year 1939.

3. In holding and deciding that the Petitioner, John H. Smith, sustained a capital loss and allowed only 50 per cent. thereof by reason of his loss of investment in San Juan Mining Syndicate. [155]

4. In holding and deciding that the Petitioner, John H. Smith, received compensation to the extent of the difference between the option price for the purchase of voting trust certificates representing Common Stock of Hawley Pulp and Paper Company, and the market value thereof during the respective years 1938 and 1939.

5. In holding and deciding that the Petitioner, John H. Smith, realized gains in the taxable years 1938 and 1939 pursuant to the exercise of his option to purchase the right to receive voting trust certificates representing Common Stock of Hawley Pulp and Paper Company.

6. In failing to hold and decide that the option which Petitioner, John H. Smith, received on December 10, 1934, was for services rendered prior to December 10, 1934, and that if any income was received by John H. Smith, Petitioner, it was the value of the option on December 10, 1934 and that such compensation was received in the calendar year 1934.

7. In failing to hold and decide that after December 10, 1934 the Petitioner, John H. Smith, was a party to a bona fide option agreement for the sale and purchase of voting trust certificates representing said Common Stock, and that any

gains upon said transaction would be reported upon the sale thereof by the Petitioner, [156] John H. Smith with a basis to determine gain or loss in the amount of 10 cents per share.

8. In deciding and ordering that there are deficiencies and income tax liabilities for the years 1938 and 1939 in the respective amounts of $33,502.64 and $29,446.16.

9. In failing to decide and order that there was no deficiency in income tax due by the taxpayer, John H. Smith for the calendar years 1938 and 1939, respectively.

CLARENCE D. PHILLIPS,
Attorney for John H. Smith,
Petitioner.

Service of a copy of the within statement of Points to be Relied Upon is hereby admitted this 29th day of May, 1943.

(S) J. P. WENCHEL,
Chief Counsel.

By .....
Attorney for Commissioner of
Internal Revenue.

[Endorsed]: T.C.U.S. Filed June 9, 1943. [157]

[Title of Circuit Court of Appeals and Cause.]

DESIGNATION OF PORTIONS OF RECORD, PROCEEDINGS AND EVIDENCE TO BE CONTAINED IN RECORD ON REVIEW

To the Clerk of the Tax Court of the United States:

You will please prepare, transmit and deliver to the Clerk of the United States Circuit Court of Appeals, for the Ninth Circuit, copies duly certified as correct of the following documents and records in the above entitled cause in connection with the Petition for Review by the Circuit Court of Appeals, for the Ninth Circuit, heretofore filed by John H. Smith, Petitioner on Review:

1. Docket entries.
2. Pleadings before the Board:

(a) Petition and copy of notice of deficiency and statement attached.

(b) Answer.

3. Opinion.
4. Board decision entered April 7, 1943.
5. The following exhibits, or portions thereof:

[158]

(a) Copy of report of Reorganization Committee of Hawley Pulp and Paper Company found on pages 1, 2, 3, 4 and 5 of Exhibit 1.

(b) Full copy of Exhibit 2.

(c) Full copy of Exhibit 3.

(d) Full copy of Exhibit 4.

(e) Full copy of Exhibit 5.

(f) Copy of page 13 of Exhibit 6 showing mar-

ket values of Hawley Pulp and Paper Company Common Stock.

(g) Full copy of Exhibit 7.

(h) Copy of Schedule E from income tax return of Western Cooperage Company for 1938, Exhibit (8) A.

6. Transcript of Testimony.

7. Petition for Review, together with proof of service of notice of filing Petition for Review and of service of a copy of Petition for Review.

8. Statement of points to be relied upon.

9. Orders of court enlarging time, if any.

10. This designation.

Said transcript to be prepared, certified and transmitted as required by law and the rules of the United States Circuit Court of Appeals for the Ninth Circuit.

CLARENCE D. PHILLIPS,
Attorney for John H. Smith,
Petitioner. [159]

Service of a copy of the within designation of portions of the record, etc., is hereby admitted and agreed to this 29th day of May, 1943.

(S) J. P. WENCHEL,
Chief Counsel.

By .....
Attorney for Commissioner
of Internal Revenue.

[Endorsed]: T.C.U.S. Filed June 9, 1943. [160]

The Tax Court of the United States
Washington

Docket No. 110050.

JOHN H. SMITH,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

CERTIFICATE

I, B. D. Gamble, clerk of The Tax Court of the United States do hereby certify that the foregoing pages, 1 to 160, inclusive, contain and are a true copy of the transcript of record, papers, and proceedings on file and of record in my office as called for by the Praecipe in the appeal (or appeals) as above numbered and entitled.

In testimony whereof, I hereunto set my hand and affix the seal of The Tax Court of the United States, at Washington, in the District of Columbia, this 16th day of June, 1943.

[Seal] B. D. GAMBLE,
Clerk, The Tax Court of the
United States.

[Endorsed]: No. 10478. United States Circuit Court of Appeals for the Ninth Circuit. John H. Smith, Petitioner, vs. Commissioner of Internal Revenue, Respondent. Transcript of the Record. Upon Petition to Review a Decision of the Tax Court of the United States.

Filed June 28, 1943.

PAUL P. O'BRIEN,

Clerk of the United States Circuit Court of Appeals for the Ninth Circuit.

UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

No. 10478

JOHN H. SMITH, PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Upon Petition to Review a Decision of the Tax Court of the United States

Proceedings had in the United States Circuit Court of Appeals for the Ninth Circuit

Excerpt from Proceedings of Friday, January 21, 1944.
Before WILBUR, DENMAN, and MATHEWS, Circuit Judges.

Order of submission

Ordered petition to review argued by Mr. Clarence D. Phillips, counsel for petitioner, and by Mr. James P. Garland, Special Assistant to the Attorney General, counsel for respondent, and submitted to the court for consideration and decision.

Excerpt from Proceedings Thursday, May 25, 1944.
Before WILBUR, DENMAN, and MATHEWS, Circuit Judges.

Order directing filing of opinion and filing and recording of judgment

By direction of the Court, ordered that the typewritten opinion this day rendered by this Court in above cause be forthwith filed by the clerk, and that a judgment be filed and recorded in the minutes of this Court in accordance with the opinion rendered.

In the United States Circuit Court of Appeals for the Ninth Circuit

No. 10478—May 25, 1944

JOHN H. SMITH, PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Petition to Review a Decision of the Tax Court of the United States

Before WILBUR, DENMAN, and MATHEWS, Circuit Judges.

MATHEWS, Circuit Judge.

Here for review is a decision of the Tax Court of the United States which determined that there were deficiencies in respect of petitioner's

income taxes for 1938 and 1939. The Tax Court held (1) that, in his return for 1938, petitioner had understated his income by $81,021.60; (2) that, in his return for 1939, he had understated his income by $71,663.98; and (3) that, in computing his net income for 1939, he had deducted, on account of a loss sustained in that year, $166.66 more than he was entitled to deduct. These holdings are assigned as error.

First. Petitioner, a resident of Oregon, was an employee of Western Cooperage Company, an Oregon corporation, hereafter called Western. Western managed Hawley Pulp & Paper Company, a Delaware corporation, hereafter called Hawley, under a contract which provided that, as compensation for managing Hawley, Western should receive 174,378 shares of common stock in Hawley. On December 10, 1934, as compensation for services theretofore rendered to Western by petitioner, Western granted petitioner an option to purchase from Western, on or before January 1, 1940, at a price of $7,437.70 (10 cents a share), 74,377 of the 174,378 shares of common stock which Western was to receive from Hawley. Petitioner exercised his option in 1938 by paying western $7,437.70.

Of the 74,377 shares of Hawley stock so purchased and paid for by petitioner in 1938, 23,759 shares were delivered to him in 1938. These shares, at the time of their delivery to petitioner, had a fair market value of $84,397.50. Thus, at the time of their delivery to petitioner, their fair market value exceeded their cost by $81,021.60. The Tax Court held that the excess ($81,021.60) was compensation for petitioner's services, hence was income to him and should have been so reported in his 1938 income-tax return and, since it was not so reported, held that petitioner had understated his income by $81,021.60.

We think that, in so holding, the Tax Court erred. Petitioner's Hawley stock was not issued to him as compensation for services, but was purchased by him pursuant to an option.[2] The option was granted him as compensation for services, but the option was not stock or the equivalent of stock. In order to acquire the stock, petitioner had to purchase it, and did purchase it. There was no finding, nor any basis for finding, that the option was intended to enable petitioner to make a "bargain purchase."[3] Instead, the Tax Court found that, at the date of the option, the market value of the stock did not exceed the option price of 10 cents a share. That the parties acted in good faith was not questioned. There was, therefore, no basis for holding that the difference between the option price of the stock and its mar-

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[1] As in Old Colony Trust Co. v. Commissioner, 1 Cir., 59 F. 2d 168; Crowell v. Commissioner, 6 Cir., 62 F. 2d 51; Olsen v. Commissioner, 7 Cir., 67 F. 2d 726; Mason v. Commissioner, 6 Cir., 125 F. 2d 540.

[2] As in Rothwell v. Commissioner, 10 Cir., 77 F. 2d 50, Rossheim v. Commissioner, 3 Cir., 92 F. 2d 247; Hawke v. Commissioner, 9 Cir., 109 F. 2d 946. See, also, Gardner Denver Co. v. Commissioner, 7 Cir., 75 F. 2d 38; Omaha National Bank v. Commissioner, 8 Cir., 75 F. 2d 434.

[3] As in Connolly's Estate v. Commissioner, 6 Cir., 135 F. 2d 64.

ket value when delivered to petitioner was compensation for his services,[4] or was income to him, or that his income was understated.

Holding, as we do, that the difference between the option price of the stock and its market value when delivered to petitioner was not income, we need not consider Article 22 (a)-1 of Treasury Regulations 101, promulgated under the Revenue Act of 1938;[5] for that which is not income cannot be made income by Treasury Regulations.[6]

If upon their delivery to him in 1938, petitioner had sold the 33,759 shares of Hawley stock at their then market value, he would have realized gain therefrom, and that gain would have constituted income; but there was no such sale. Petitioner did not sell or dispose of any of his Hawley stock until 1940.

Second. Of the 74,377 shares of Hawley stock purchased and paid for by petitioner in 1938, 12,374 shares were delivered to him in 1939. These shares, at the time of their delivery to petitioner, had a fair market value of $72,901.38. Thus, at the time of their delivery to petitoner, their fair market value exceeded their cost by $71,663.98. The Tax Court held that the excess ($71,663.98) was compensation for petitioner's services, hence was income to him and should have been so reported in his 1939 income tax return and, since it was not so reported, held that petitioner had understated his income by $71,663.98.

We think that, in so holding, the Tax Court erred. The reasons for this conclusion have been stated already and need not be repeated.

Third. On July 17, 1937, petitioner purchased four units of interest in San Juan Mining Syndicate, hereafter called San Juan, for $1,000. The units became worthless on or about April 25, 1939, and were charged off by petitioner. In computing his net income for 1939, petitioner deducted, on account of the loss resulting from the units becoming worthless, $666.66 (two-thirds of $1,000). He contended before the Tax Court, and contends here, that the loss was an ordinary loss incurred in a transaction entered into for profit, and that therefore he was entitled to deduct the full amount thereof ($1,000). The Tax Court held that San Juan was a corporation; that units of interest in San Juan were shares of stock in a corporation and hence were securities; that the loss resulting from the units becoming worthless should be considered as a loss from a sale or exchange of capital assets on the last day of 1939; and that therefore petitioner was entitled to deduct only 50% ($500) of the loss.[7]

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[4] See cases cited in footnote 2.

[5] Article 22(a)-1 provides: "If property is transferred to a shareholder, or by an employer to an employee, for an amount substantially less than its fair market value, regardless of whether the transfer is in the guise of a sale or exchange, such shareholder or employee shall include in gross income the difference between the amount paid for the property and the amount of its fair market value to the extent that such difference is in the nature of (1) compensation for services rendered or to be rendered or (2) a distribution of earnings or profits taxable as a dividend, as the case may be."

[6] Commissioner v. Van Vorst, 9 Cir., 59 F. 2d 677; Hawke v. Commissioner, supra.

[7] Revenue Act of 1938, § 23 (e).

[8] Revenue Act of 1938, §§ 23 (g), 117 (a), 117 (b), 901 (a).

Petitioner contends that San Juan was not a corporation, but was merely a syndicate, and that therefore the Tax Court's holding was wrong. As used in the Revenue Act of 1938, the term "corporation" includes "associations, joint-stock companies, and insurance companies." [9] A syndicate may be an association and hence a corporation, within the meaning of the Act.[10] Respondent, the Commissioner of Internal Revenue, determined that San Juan was a corporation. No evidence to the contrary was offered by petitioner. Accordingly, and properly, the Tax Court accepted respondent's determination and held that petitioner was entitled to deduct only $500 of the loss resulting from the units becoming worthless. In this we find no error.

Decision reversed and case remanded for further proceedings in conformity with this opinion.

(Endorsed:) Opinion. Filed May 25, 1944. Paul P. O'Brien, Clerk.

Judgment

Upon Petition to Review a Decision of the Tax Court of the United States.

This cause came on to be heard on the Transcript of the Record from the Tax Court of the United States and was duly submitted:

On consideration whereof, it is now here ordered and adjudged by this Court, that the decision of the said Tax Court in this cause be, and hereby is reversed, and that this cause be, and hereby is remanded to the said Tax Court for further proceedings in conformity with the opinion of this court.

(Endorsed:) Judgment. Filed and entered May 25, 1944. Paul P. O'Brien, Clerk.

I, Paul P. O'Brien, as Clerk of the United States Circuit Court of Appeals for the Ninth Circuit, do hereby certify the foregoing one hundred and seventy-nine (179) pages, numbered from and including 1 to and including 179, to be a full, true, and correct copy of the entire record of the above-entitled case in the said Circuit Court of Appeals, made pursuant to request of Hon. Charles Fahy, Solicitor General of the United States, counsel for the respondent, and certified under Rule 38 of the Revised Rules of the Supreme Court of the United States, as the originals thereof remain on file and appear of record in my office.

Attest my hand and the seal of the said the United States Circuit Court of Appeals for the Ninth Circuit, at the City of San Francisco, in the State of California, this 1st day of August 1944.

[SEAL] PAUL P. O'BRIEN, *Clerk.*

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[9] Revenue Act of 1938, § 901 (a) (2).
[10] Helm & Smith Syndicate v. Commissioner, 9 Cir., 136 F. 2d 449.

U. S. GOVERNMENT PRINTING OFFICE: 1944

Supreme Court of the United States

Order allowing certiorari

Filed October 16, 1944

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Ninth Circuit is granted, and the case is transferred to the summary docket.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

U. S. GOVERNMENT PRINTING OFFICE: 1945